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An Argument for Simplifying the Code's "Small Business Debtor" Definition

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AN ARGUMENT FOR SIMPLIFYING THE CODE'S "SMALL BUSINESS DEBTOR" DEFINITION

ANNE LAWTON*

In 2005, Congress enacted a number of small business reforms aimed at improving the dismal plan confirmation and performance rates of chapter 11 small business debtors. The reforms required increased reporting by and monitoring of small business debtors as well as "drop dead" dates for plan proposal and confirmation. To facilitate the sorting of small from non-small business debtors, Congress adopted a detailed definition of a "small business debtor" as part of its reform package. That definition included two predictors of plan success—creditor committee formation and debtor liability size. However, Congress cluttered up the definition with useless modifiers and undefined qualifiers, thereby undermining its efficacy as a means for identifying those debtors at risk for chapter 11 failure.

In this Article, I propose radically simplifying the Code's "small business debtor" definition by eliminating all but two criteria—formation of an official creditors' committee and size of a debtor's liabilities—from the current definition. The legislative history provides little insight into why Congress selected many of the criteria that it did when devising the Code's definition of a small business debtor. Most of the choices that Congress made also undermine the goal of identifying early in the case those debtors at high risk for chapter 11 failure.

Furthermore, the simplified definition provides a very good mechanism for sorting small from non-small business debtors. Using a random sample of 782 chapter 11 cases filed in 2004, one year prior to the 2005 small business reforms, I conducted a Chi-square test for independence to compare the confirmation and plan performance rates of small versus non-small chapter 11 debtors. I found non-small business debtors, defined as any case with a creditors' committee and/or total liabilities in excess of the \$2 million liability cutoff in effect in 2004, confirmed and successfully performed plans at significantly higher rates statistically ($p < 0.001$) than did small business debtors, i.e., those without a creditors' committee and liabilities below the \$2 million limit.

I conclude the Article with an acknowledgment of some possible minor shortcomings in my proposed revision of the "small business debtor" definition.

* Associate Professor, Michigan State University College of Law. Copyright 2012 Anne Lawton. I wish to acknowledge Scott Nagele, MSU College of Law, who created the database on which this Article's findings are based. I also want to thank Jane Meland of MSU College of Law for her invaluable assistance in researching the legislative history of the various small business proposals. Finally, I am indebted to the chief bankruptcy judges who granted me PACER fee waivers in order to undertake the empirical research that forms the basis for this Article's findings and analysis.

Nonetheless, I caution against scuttling a simple definition with strong predictive power out of a misguided belief that definitional perfection is attainable.

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INTRODUCTION

In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"),¹ which drew much attention for its substantial changes to consumer bankruptcy practice, in particular the addition of the much-maligned "means" test.² BAPCPA, however, also shepherded in a host of reforms applicable

¹ Pub. L. No. 109-8, 119 Stat. 23 (2005). Throughout the footnotes, I refer to the Bankruptcy Abuse Prevention and Consumer Protection Act as BAPCPA.

² See, e.g., Benjamin F. Davis, IV, *"Before the Law Sits A Gatekeeper": Finding Brilliance in the Attorney Liability Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act*, 23 EMORY BANKR. DEV. J. 285, 285 (2006) (stating that Congress expected

to small business debtors.³ Judges and legal commentators alike have questioned the need for, and bemoaned the impact of, these small business reforms.⁴ In this Article, I do not intend to jump into that fray. Instead, assuming *arguendo* that Congress was right about the need for small business reform, I examine whether Congress created a mechanism for identifying small business debtors that facilitates the goals underpinning BAPCPA's small business reforms.

The small business reforms arose out of concerns that small business debtors fared poorly in chapter 11; their cases languished while administrative costs increased and their prospects for plan confirmation decreased.⁵ In response, Congress enacted a series of reforms requiring increased reporting by and monitoring of small business debtors as well as "drop dead" dates for plan proposal and confirmation.⁶

BAPCPA to markedly affect bankruptcy practice); Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 603 (2005) (footnote omitted) (noting that "[m]ost press coverage of [BAPCPA] focused on the provisions affecting consumer debtors"); Ned W. Waxman & Justin H. Rucki, *Chapter 7 Bankruptcy Abuse: Means Testing Is Presumptive, but "Totality" Is Determinative*, 45 HOUS. L. REV. 901, 902–03 (2008) (noting that Congress created "means" test to address abuses by debtors).

³ See Thomas E. Carlson & Jennifer Frasier Hayes, *The Small Business Provisions of the 2005 Bankruptcy Amendments*, 79 AM. BANKR. L.J. 645, 667 (2005) (providing excellent analysis and summary of BAPCPA's small business reforms).

⁴ See, e.g., Hon. James B. Haines, Jr. & Philip J. Hendel, *No Easy Answers: Small Business Bankruptcies After BAPCPA*, 47 B.C. L. REV. 71, 72 (2007) (noting that "value of BAPCPA's reforms is outweighed by the procedural burdens the statute imposes on small business debtors"); Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 603 (2009) (providing empirical analysis of chapter 11 cases and questioning conventional wisdom underpinning BAPCPA's reforms that Chapter 11 debtors spend too much time in bankruptcy); see also Stephen J. Lubben, *Chapter 11 "Failure"* 5 (Seton Hall Univ. Sch. of Law, Working Draft), available at <http://ssrn.com/abstract=1375163> (noting based on empirical study of pre-BAPCPA chapter 11 cases that BAPCPA might have been "largely unnecessary, inasmuch as [the 2005 amendments] amount[ed] to little more than the *coup de grâce* for a group of cases that already were unlikely to make it through chapter 11").

⁵ See NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 613 (1997) [hereinafter 1997 COMMISSION REPORT] (footnote omitted) (noting that "studies reveal that Chapter 11 debtor [sic] often live under the protection of the Bankruptcy Code for literally years"). See *infra* notes 41–44 and accompanying text for explanation of why Commission's Report is central to understanding BAPCPA's small business reforms.

⁶ See 11 U.S.C. § 1116(1) (2006) (requiring small business debtors to attach additional financial information to their voluntary petitions); *id.* § 1121(e)(2) (requiring that plan be filed in small business case within 300 days of petition); *id.* § 1129(e) (providing that bankruptcy court confirm small business plan within 45 days of its filing); 28 U.S.C. § 586(a)(7) (2006) (setting forth duties of United States trustee in small business cases).

Central to the success of the reform package is the early identification of those debtors at risk for chapter 11 failure.⁷ The "small business debtor" definition supposedly serves that purpose. While Congress included two of the predictors of chapter 11 success in the Bankruptcy Code's (the "Code") definition, it also included a number of other conditions that render early identification more time consuming, expensive, and uncertain. Rather than adopting a bright-line definition, Congress crafted a definition riddled with qualifiers, both defined and undefined. The "small business debtor" definition, however, is only a means to an end. It should operate as a rough sorting mechanism—quickly and cheaply identifying those debtors with poor prospects for success in chapter 11. The definition that Congress enacted in BAPCPA, however, fosters uncertainty and creates a breeding ground for litigation, thereby interfering not only with the debtor's ability to concentrate on confirming a plan but also with the United States trustee's⁸ ability to focus on the merits of the debtor's reorganization efforts.

Thus, I propose radically simplifying the Code's definition of a small business debtor, retaining only two of the Code's current criteria—official creditor committee formation and liability size—for sorting small from non-small business debtors. In Part I, I survey the legislative history of both BAPCPA and the Bankruptcy Reform Act of 1994 ("1994 Act"),⁹ which first defined the term "small business." The absence of any explanation in the legislative history for Congress' definitional choices strongly suggests that Congress acted haphazardly rather than methodically when it adopted the current definition of a small business debtor.

After proposing a simplified "small business debtor" definition, I then undertake in Part II to explain the reasons for the changes that I propose. In Part II.A.1, I recommend deleting the Code's requirement that the small business debtor be engaged in "commercial or business activities," because no evidence exists

⁷ See *In re Root Rents, Inc.*, 420 B.R. 28, 38 (Bankr. D. Idaho 2009) (stating in small business case "it is critical to know at the outset of the case" if additional "obligations and requirements" imposed on small business cases apply).

⁸ The United States trustee program does not operate in North Carolina or Alabama. See *infra* notes 166–68 and accompanying text. Instead, Bankruptcy Administrators, who are judicial employees, perform many functions performed by the United States trustee. See 1 COLLIER ON BANKRUPTCY, ¶ 6.01, at 6-15–6-16 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012). Nonetheless, "while the Bankruptcy Administrator's position is analogous to that of the United States trustee, the Bankruptcy Administrator may not operate in the same manner." *Id.* at 6-16. In this Article, then, I intend for the term "United States trustee" to include "Bankruptcy Administrator" to the extent provided for and allowed by the Code and bankruptcy rules. See FED. R. BANKR. P. 9035 (2011) (providing that in any case in North Carolina or Alabama "and in which a United States trustee is not authorized to act, these rules apply to the extent that they are not inconsistent with any federal statute effective in the case").

⁹ Bankruptcy Reform Act of 1994, H.R. 5116, 103d Cong. § 217(a), 108 Stat. 4106, 4127 (1994) [hereinafter 1994 Act].

supporting a distinction between chapter 11 consumer and business debtors. Part II.A.2 suggests that Congress erroneously excluded from the pool of small business debtors those debtors whose "primary activity is the business of owning or operating real property."¹⁰ The legislative history indicates that Congress mistakenly carried over this real property exclusion from legislative proposals to create a "chapter 10" for small business debtors without recognizing that the exclusion made no sense in the context of chapter 11.

In Part II.A.3, I propose simplifying the calculation of a debtor's liabilities by eliminating the requirement to deduct "contingent," "unliquidated," "affiliate" and "insider" debt in order to determine whether a debtor's liabilities fall above or below the current \$2,490,925 liability cutoff for small business debtors. The debtor's schedules and statements do not provide in a simple format the numbers necessary for the United States trustee to easily verify the liability calculations required by the Code. Moreover, deduction of contingent, unliquidated, affiliate and insider debt is simply unnecessary. As I discuss in Part II.A.5 *infra*, debtor liabilities predict plan success regardless of whether liability totals include or exclude contingent, unliquidated, affiliate and insider debt.

In Part II.A.4, I recommend dropping the reference to the United States trustee in the Code's "small business debtor" definition. The restrictive language opens up the possibility that a chapter 11 case with an official creditors' committee may nonetheless qualify as a small business in North Carolina and Alabama, where the United States trustee does not operate.

In Part II.A.5, I summarize the findings of an empirical study that I conducted using a random sample of 782 chapter 11 cases filed in 2004. In *Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success* ("Success Study"),¹¹ I found that official creditor committee formation and liability size *each* independently predicts a debtor's chances of confirming and successfully performing a chapter 11 plan.¹² For this Article, I conducted a Chi-square test for independence on plan confirmation and successful performance rates using the two elements in the modified definition of a small business debtor to classify the 782 debtors in the random sample. The results of that statistical analysis, presented in Part A.II.5, demonstrate that non-small business debtors, i.e., those with an official committee and/or scheduled liabilities in excess of \$2 million (the liability cutoff in 2004), confirmed and successfully performed plans at significantly higher rates than did small business debtors, i.e., those with no committee and scheduled liabilities at or below the \$2 million threshold.

Finally, in Part II.B, I recommend eliminating the requirement that "contingent," "unliquidated," "affiliate" and "insider" debt be deducted in

¹⁰ 11 U.S.C. § 101(51D).

¹¹ Anne Lawton, *Chapter 11 Triage: Diagnosing A Debtor's Prospects for Success*, 54 ARIZ. L. REV. 985 (2012).

¹² *Id.* at 1025.

determining small business status for any member of a group of affiliated chapter 11 debtors. I conclude by addressing concerns about retaining committee formation as a criterion for sorting small from non-small business debtors. I end on a cautionary note about the costs of excessive tinkering, warning not to scuttle a simple definition with strong predictive power in the quest for definitional perfection.

I. A LITTLE BIT OF HISTORY¹³

Congress worked a major overhaul of the nation's bankruptcy laws with the enactment of the Bankruptcy Code in 1978.¹⁴ The Code consolidated several reorganization chapters of the Bankruptcy Act,¹⁵ creating the new chapter 11,¹⁶ intended primarily, though not exclusively, for firms wanting to reorganize their business rather than liquidate in chapter 7.¹⁷ The consolidation solved one problem plaguing the old Bankruptcy Act: litigation over reorganization chapter choice.¹⁸ But, critics of the new chapter 11 soon emerged. Some claimed that Congress had exchanged one problem—chapter shopping under the old Bankruptcy Act—for a new problem—a "one-size-fits-all" system ill-suited to the needs of small chapter 11 debtors.¹⁹

In the early 1990s, Congress began exploring a return to pre-Code days, considering the creation of separate reorganization chapters for small and large

¹³ See *id.* at 993–94 for a detailed look at the legislative history of the small business reforms.

¹⁴ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) [hereinafter 1978 Code].

¹⁵ See H.R. DOC. NO. 93-137, at 23 (1973), reprinted in B-C COLLIER ON BANKRUPTCY D APP. Pt. 4(c) 18 (2011) [hereinafter 1973 Commission Report] (explaining three main business reorganization chapters of Bankruptcy Act and recommending their consolidation into single chapter).

¹⁶ See 1978 Code, *supra* note 14, at §§ 1101–1146, 92 Stat. at 2626–41; see also 1997 COMMISSION REPORT, *supra* note 5, at 304 (noting that "major change in the 1978 Code involved the consolidation of three chapters and approaches").

¹⁷ Chapter 11 allows debtors to liquidate, in whole or in part. See 11 U.S.C. § 1123(b)(4) (2006). Chapter 11 also does not require that a debtor be engaged in business. See *infra* Part II.A.1 (defining commercial-or-business-activities proviso).

¹⁸ See 1973 Commission Report, *supra* note 15, at 23 (footnote omitted) (analogizing "pointless and wasteful litigation" over chapter choice under Bankruptcy Act to "patient [who would] probably die while the doctors argue[d] over which operating table he should be on").

¹⁹ See, e.g., Ralph A. Peeples, *Staying in: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65, 71 (1989) (noting that legislative history of Bankruptcy Reform Act of 1978 was silent on "possibility that the special nature of close corporations might make special bankruptcy provisions appropriate").

business debtors. Commentators bemoaned the apparently lackluster performance of small business debtors in chapter 11.²⁰ Critics claimed that the complexity and cost of chapter 11 too often derailed small debtors' reorganization efforts.²¹ The success of Judge A. Thomas Small's "fast-track" procedure in the Eastern District of North Carolina spurred legislative proposals for a new chapter 10 for small business debtors.²² Those proposals, however, never made their way into law.

Instead, in the 1994 Act, Congress created a small business election designed "to expedite the process by which small businesses [could] reorganize under chapter 11."²³ Congress also created the National Bankruptcy Review Commission (the "Commission") and tasked the Commission with "reviewing, improving, and updating the Code."²⁴ With the Commission's creation, Congress sought a fine-tuning, rather than a major overhaul, of the Code.²⁵ Three years later, the Commission issued its report.²⁶

The Commission made ten small business recommendations aimed at "strengthen[ing] the 1994 'small business' amendments to reduce the cost and delay in small business Chapter 11 cases."²⁷ Citing the failure of the small business

²⁰ In an early empirical study of chapter 11 debtors in the Western District of Missouri, Professor Lynn LoPucki found that the cases in his study fell into one of "two largely distinguishable groups": (1) "large manufacturers" with a "high probability of success (86%)"; and (2) "small manufacturers and all other debtors" with a "very low probability of success (15%)." Lynn M. LoPucki, *The Debtor in Full Control – Systems Failure under Chapter 11 of the Bankruptcy Code (First Installment)*, 57 AM. BANKR. L.J. 99, 100 (1983).

²¹ See, e.g., Karen Gross and Patricia Redmond, *In Defense of Debtor Exclusivity: Assessing Four of the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 287, 287 (1995) (footnote omitted) (stating that chapter 11 had been under attack with critics claiming it "cost[] too much and [took] too long"); Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 730–31 (1993) (attributing problems plaguing chapter 11, including cost and poor success rates, to fact that debtors are allowed to remain under bankruptcy court protection for "excessive" periods of time).

²² See, e.g., *The Bankruptcy Amendments Act of 1993: Hearing before the Subcomm. on Courts and Admin. Practice of the S. Comm. on the Judiciary*, 103d Cong. 162, 163 (1993) (statement of William J. Perlstein of the American Bankruptcy Institute) (praising Judge Small and proposed chapter 10 pilot program); *Commercial and Public Sector Issues in Bankruptcy, Hearing before the Subcomm. on Econ. and Comm. Law of the H. Comm. on the Judiciary*, 102d Cong. 389, 394 (1992) [hereinafter 1992 Hearings] (statement of Charles M. Tetelbaum of the National Assn. of Credit Mgt.) (praising Judge Small's success and proposing new chapter 10 modeled on his fast-track procedure).

²³ H.R. REP. NO. 103-835, at 50 (1994).

²⁴ *Id.* at 59. Congress noted that it was "generally satisfied with the basic framework established" by the Code. *Id.*

²⁵ See *id.*

²⁶ The Commission submitted its report on October 20, 1997. See 1997 COMMISSION REPORT, *supra* note 5, at 74.

²⁷ *Id.* at 609.

election, the Commission recommended making small business treatment mandatory.

The Commission recommends that choice of treatment as a "small business" debtor under the Bankruptcy Code should not be optional Otherwise, the separate track will not likely be used. Few debtors will elect to expedite their Chapter 11 cases or submit to greater supervision by the court and U.S. Trustee. The unpopularity of the 1994 amendments to the Bankruptcy Code concerning "small business" debtors, which have been largely ignored, confirms this hypothesis.²⁸

A basic goal of the proposed reforms was early identification of the so-called "dead-on-arrival" debtor, thereby allowing the United States trustee to shepherd the case more quickly toward dismissal from chapter 11 or conversion to chapter 7.²⁹ The goal of early identification, given the limited information available at the start of a chapter 11 case, however, pushed the Commission toward what it considered a "bright-line" definition of a small business debtor.³⁰ The 1994 Act defined a "small business" as any

person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed \$2,000,000.³¹

The Commission opted for a simpler definition, eliminating the 1994 Act's requirements that a debtor be engaged in "commercial or business activities" and *not* engaged in the "primary activity of owning or operating real property." The Commission defined a "small business debtor" as

[a]ny debtor in a case under Chapter 11 (including any group of affiliated debtors) which has aggregate noncontingent, liquidated secured and unsecured debts as of the petition date or order for relief of five million dollars (\$5,000,000) or less or any single asset real estate debtor as defined in 11 U.S.C. §101(51B), regardless of such debtor's liabilities.³²

²⁸ *Id.* at 634-35.

²⁹ *See id.* at 308, 312, 609-10.

³⁰ *See id.* at 628.

³¹ 1994 Act, *supra* note 9, at § 217(a), 108 Stat. at 4127.

³² 1997 COMMISSION REPORT, *supra* note 5, at 618 (footnote omitted).

The Commission noted the inherent trade-offs between precision and ease of identification in any effort to define a small business debtor. But, it felt that a "searching inquiry by the court under a multifaceted definition" would result in litigation at the start of the chapter 11 case, thereby distracting the parties from the central inquiry—"the merits of the [debtor's] Chapter 11 case."³³

Congress obviously agreed with the Commission's assessment of the problems plaguing chapter 11 small business debtors. In 2005, with BAPCPA's passage, Congress "adopted largely intact each of the Commission's small business recommendations."³⁴ For some reason left unexplained by the legislative history, however, Congress did not adopt the Commission's "small business debtor" definition.³⁵ Instead, it crafted the following definition:

The term "small business debtor" –

(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more than \$2,000,000³⁶ (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured

³³ *Id.* at 628.

³⁴ Carlson & Hayes, *supra* note 3, at 647.

³⁵ See Lawton, *supra* note 11, at 991–95 (detailing differences between Commission's and Congress' definitions); 2 COLLIER ON BANKRUPTCY ¶ 101.51D, at 101-204 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012) [hereinafter Collier Definition] (noting that Code's small business definition "diverges from the Commission's recommendations in several ways").

³⁶ In 2004, \$2 million was the liability cutoff. The Code requires the adjustment of the dollar figure in the "small business debtor" definition every three years. See 11 U.S.C. § 104(a) (2006). The current liability cutoff for small business debtors is \$2,490,925. See 11 U.S.C. § 101(51D) (West 2012). The next adjustment will occur in April of 2016.

and unsecured debts in an amount greater than \$2,000,000 (excluding debt owed to 1 or more affiliates or insiders).³⁷

Congress, then, rejected the Commission's recommendation for a bright-line definition. The question is: "why?" Moreover, was Congress right in doing so?

II. KEEPING IT SIMPLE

Nothing in BAPCPA's legislative history explains why Congress rejected the Commission's definition of a small business debtor.³⁸ Nonetheless, Congress may have been right in doing so. Making that determination, however, requires answers to two questions. First, what did Congress hope to achieve with adoption of BAPCPA's small business reforms? Second, does the Code's current small business definition better accomplish Congress' objective than the Commission's proposed definition?

The difficulty in answering the first question is the dearth of explanation in the legislative history about what Congress sought to accomplish by adopting the small business reforms. The section-by-section analysis of the small business reforms in the House Report accompanying BAPCPA largely consists of a restatement of the language of the small business provisions.³⁹

Congress [] provided little legislative history to help practitioners and the courts interpret the Small Business Provisions. The only legislative history regarding these provisions in the 109th Congress consists of one committee report and very limited testimony by one witness. The committee report does little more than paraphrase the statutory language. The testimony, critical of the Small Business Provisions, did not attempt to explain their operation, and did not induce Congress to make any changes to those provisions.⁴⁰

While the legislative history offers little guidance, the Commission's report provides a detailed explanation of the reasons for the Commission's recommendations. The

³⁷ Bankruptcy Abuse Prevention and Consumer Protection Act § 432(a), Pub. L. No. 109-8, 119 Stat. 23, 110 (2005).

³⁸ See H.R. REP. NO. 109-31, pt. 1, at 90 (2005) [hereinafter BAPCPA House Report] (one-paragraph explanation of definition of small business debtor does little more than duplicate language of statutory provision); Collier Definition, *supra* note 35, at 101-204 (noting "legislative history regarding the definition essentially repeats the statute and does not explain why the recommendations of the Commission were rejected").

³⁹ See BAPCPA House Report, *supra* note 38, at 90-96 (summarizing small business bankruptcy provisions).

⁴⁰ Carlson & Hayes, *supra* note 3, at 647.

paucity of legislative history, coupled with Congress' extensive adoption of the Commission's recommendations, renders the Commission's Report "the most authoritative source available."⁴¹

In its report, the Commission explained that "a major objective" of its proposed reforms was "to improve techniques for early identification of those debtors which have a reasonable probability of succeeding in chapter 11 and those which do not."⁴² To that end, the Commission recommended provisions creating increased reporting by and more oversight of small business debtors.⁴³ For example, the Commission proposed, and Congress adopted, a requirement that small business debtors append to the voluntary petition their "most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return."⁴⁴ This additional financial reporting requirement, however, applies only to small business debtors. Therefore, a small business debtor must know that it is a small business debtor in order to comply with the Code's directive, and that is where the Code's definition comes into play.

The "small business debtor" definition performs a sorting function. Those satisfying the definition, according to Congress, are at high risk of chapter 11 failure and, hence, require closer scrutiny. A bright-line definition, as suggested by the Commission, facilitates that early sorting process. A complex and ambiguous definition, like the one adopted by Congress, increases the possibility of confusion and litigation, which delay debtor identification and increase costs.

This is not to say that Congress erred in not adopting the Commission's definition. In fact, Congress actually did a better job than the Commission at identifying the factors that predict chapter 11 success.⁴⁵ The Commission's definition omitted a significant predictor—official creditor committee formation—that Congress added to the small business definition in 2005 with the passage of BAPCPA.⁴⁶ Yet neither the Commission nor Congress got it quite right. Congress failed to heed the Commission's exhortation to create a "bright-line definition" that would "minimize[] litigation and enable[] the court and counsel to focus on the merits of the Chapter 11 case."⁴⁷ Moreover, both the Commission and Congress

⁴¹ *Id.*

⁴² 1997 COMMISSION REPORT, *supra* note 5, at 639.

⁴³ *See id.* at 641–42.

⁴⁴ 11 U.S.C. § 1116(1) (2006).

⁴⁵ *See* Lawton, *supra* note 11, at 1022 (noting that Congress's \$2 million cutoff for committee formation and debtor liability size was better predictor of chapter 11 plan success than Commission's \$5 million cutoff).

⁴⁶ *See id.* at 995 (stating committee proviso is one of many differences between what Congress adopted for small business debtor definition and what Commission recommended).

⁴⁷ 1997 COMMISSION REPORT, *supra* note 5, at 628.

made the computation of debtor liabilities needlessly complex by requiring the subtraction of contingent and unliquidated debt from debtors' liability totals.⁴⁸

The Commission, however, had the right general idea: keep it simple. The problem with the Code's "small business debtor" definition is its complexity and imprecision. The definition is riddled with qualifiers—both defined and undefined—all of which operate not only to exclude debtors from the operation of BAPCPA's small business amendments but also to increase uncertainty about which debtors actually qualify as small business debtors. Thus, I propose amending the Code's current definition to read, as follows:

The term "small business debtor"⁴⁹ —

(A) subject to subparagraph (B), means a person that has secured and unsecured debts as of the date of the petition or the order for relief in an amount not exceeding \$2,490,925 for a case in which a committee of unsecured creditors has not been appointed under section 1102(a)(1) or the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate secured and unsecured debts in an amount greater than \$2,490,925.

The proposed revision does the following:

1. Eliminates the requirement that chapter 11 debtors be engaged in commercial or business activities (the "commercial-or-business-activities proviso") and deletes, as part of that change, the language "including any affiliate . . . that is also a debtor under this title" in the first half of the parenthetical in subpart (A);

⁴⁸ See *infra* Part II.A.3.a.

⁴⁹ I retain the term "small business debtor," as did the Commission, even though my and the Commission's definition apply to both small business and consumer debtors. See 1997 COMMISSION REPORT, *supra* note 5, at 618 (defining "small business debtor"). Otherwise, the definitional change would necessitate changes throughout the Code because a "small business case" is defined as a case in which the "debtor is a small business debtor." 11 U.S.C. § 101(51C). See, e.g., 11 U.S.C. § 1116 (describing duties of debtor in small business cases); 11 U.S.C. § 1121(e) (establishing exclusivity and plan proposal times for small business cases). Moreover, it would be odd to leave intact the references to a "small business case" in the Code but change a "small business debtor" to a "small debtor."

2. Eliminates the Code's current exclusion from the pool of small business debtors of any debtor whose "primary activity is the business of owning or operating real property" (the "real property exclusion");
3. In subpart (A), deletes the requirement that "contingent," "unliquidated," "affiliate" and "insider" debt be deducted from the debtor's liability total in order to determine small business status;
4. Deletes the reference to the United States trustee in subpart (A) in order to cover creditor committee appointments in cases filed in North Carolina and Alabama; and
5. Deletes the requirement in subpart (B) that "contingent," "unliquidated," "affiliate", and "insider" debt be deducted from the aggregate liability total for a group of affiliated debtors.

In Parts II.A.1 through 4 below, I discuss the definitional changes recommended in bullet points 1-5 above. I explain how the legislative history demonstrates that deliberate design does not lay behind the choices that Congress made in crafting the Code's current "small business debtor" definition. Instead, the definition actually undermines the goal of early identification and needlessly complicates the initial sorting of chapter 11 cases into small and non-small businesses. In Part II.A.5, I present the results of the Success Study, as well as a statistical analysis of how well the simplified "small business debtor" definition performs at sorting chapter 11 debtors. After all, the goal of this statutory drafting exercise is not only simplification but also prediction. As discussed in greater detail below, the simplified definition does a very good job of predicting, on the basis of only two criteria, a chapter 11 debtor's prospects for success. Finally, in Part II.B., I explain the changes that I recommend to the Code's small business definition as it applies to a group of affiliated debtors that file for chapter 11.

A. Subpart (A) of the Definition

1. The Commercial-or-Business-Activities Proviso

The Code requires that a small business debtor be "engaged in commercial or business activities."⁵⁰ The commercial-or-business-activities proviso does not require that the debtor be engaged in business at the time of the bankruptcy filing.⁵¹ But, a debtor with no business or commercial interests—either ongoing or shuttered prior to bankruptcy—does not qualify as a small business debtor.

⁵⁰ 11 U.S.C. § 101(51D).

⁵¹ See Collier Definition, *supra* note 35, at 101-201–202 (explaining "small business debtor" definition "is not restricted to a person who at the time of the filing of the petition is presently engaged in commercial or business activities and who expects to continue in those same activities under a plan of reorganization").

In *Toibb v. Radloff*, the Supreme Court held that the Bankruptcy Code does not require that a debtor be engaged in business *at all* in order to file for relief under chapter 11.

The plain language of the Bankruptcy Code permits individual debtors not engaged in business to file for relief under Chapter 11. Although the structure and legislative history of Chapter 11 indicate that this Chapter was intended primarily for the use of business debtors, the Code contains no "ongoing business" requirement for Chapter 11 reorganization, and we find no basis for imposing one.⁵²

Thus, consumer debtors may file for chapter 11 and, in fact, the voluntary petition requires debtors to check one of two boxes identifying their debts as primarily consumer or primarily business.⁵³ For example, a consumer debtor might file for chapter 11 because she does not wish to liquidate her assets in chapter 7 but her liabilities exceed the Code's secured or unsecured debt limits for individual reorganization under chapter 13.⁵⁴

The question is why Congress *excluded* chapter 11 consumer debtors from the Code's small business provisions. Congress defined a small business for the first time with the small business debtor election in the 1994 Act.⁵⁵ Yet, the legislative history to the 1994 Act sheds no insight on Congress' decision to limit the election to chapter 11 debtors engaged in business.⁵⁶ The Commission took a simpler approach. While Congress defined a "small business debtor" as a "person engaged in commercial or business activities," the Commission defined the same term as "any debtor in a case under Chapter 11."⁵⁷ Therefore, the Commission's definition, though of a "small *business* debtor," included both consumer and business debtors within its scope. In 2005, Congress did not follow the Commission's lead and instead retained the "commercial-or-business-activities" proviso when it enacted

⁵² *Toibb v. Radloff*, 501 U.S. 157, 166 (1991).

⁵³ See Voluntary Petition, Official Form 1, COLLIER PAMPHLET EDITION, PART 2: BANKRUPTCY RULES, at F-1 (2011) [hereinafter Voluntary Petition].

⁵⁴ In order to file for chapter 13, an individual debtor may not have non-contingent liquidated unsecured debt in excess of \$383,175 *or* non-contingent liquidated secured debt above \$1,149,525. See 11 U.S.C. § 109(e) (West 2012). The debtor must satisfy both the secured and unsecured debt limits. Thus, a debtor with unsecured debt of \$250,000, but secured debt of \$1.2 million does not qualify for chapter 13.

⁵⁵ See 1994 Act, *supra* note 9, at § 217(a), 108 Stat. at 4127.

⁵⁶ See H.R. REP. NO. 103-835, at 50 (1994) (merely summarizing in paragraph proposed small business election).

⁵⁷ 1997 COMMISSION REPORT, *supra* note 5, at 618. Section 2.5.1 of the Commission's recommendations is entitled "Defining the term 'Small Business,'" but the language of the definition includes more than business entities. See *supra* note 32 and accompanying text.

BAPCPA's small business reforms. Once again, however, BAPCPA's legislative history is silent as to why Congress excluded chapter 11 consumer debtors from the small business reforms.⁵⁸

While there is no legislative history to explain the exclusion of consumer debtors, it appears that the exclusion was purposeful on Congress' part. With BAPCPA, Congress added a parenthetical aside to the "commercial-or-business-activities" proviso.⁵⁹ The 1994 Act defined a "small business" as a "person engaged in commercial or business activities."⁶⁰ BAPCPA defined a "small business debtor" as a "person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title)."⁶¹ What purpose does the parenthetical language serve, if not to include within the pool of small business debtors a consumer debtor that is an affiliate of a chapter 11 business debtor?

[A]n affiliate of a small business debtor can be deemed to be a small business even if the affiliate is not involved in a commercial business. For example, an individual who owns a business will be a small business debtor if the business and the individual have to file bankruptcy, even though the individual is not involved in commercial or business activities.⁶²

But why slice the pie so thin? What basis exists for distinguishing between the individual consumer debtor who owns a small business enterprise that also is in bankruptcy, and the individual consumer debtor who files for chapter 11 because her liabilities exceed the cutoff for a chapter 13 case? Moreover, what end is served by increasing the complexity of the sorting mechanism that the "small business debtor" definition serves?

The exclusion is baffling. The concerns about the complexity and cost of chapter 11 for small business debtors also apply to chapter 11 consumer debtors.⁶³ With BAPCPA, Congress increased the oversight responsibilities of the United States trustee as a way to compensate for the absence of such oversight by creditor

⁵⁸ See BAPCPA House Report, *supra* note 38, at 19, 90–96 (summarizing proposed changes for small business debtors but providing no explanation of consumer debtor exclusion).

⁵⁹ *Id.* at 90.

⁶⁰ 1994 Act, *supra* note 9, at § 217(a), 108 Stat. at 4127.

⁶¹ 11 U.S.C. § 101(51D)(A) (2006).

⁶² 5 NORTON BANKRUPTCY LAW AND PRACTICE § 107:1, at 2 (William L. Norton, Jr. ed., 3d ed. 2012).

⁶³ See Lawton, *supra* note 11, at 991 (arguing that cost and complexity of chapter 11 affect not only small chapter 11 business debtors but also small non-business debtors).

committees in small business cases.⁶⁴ Yet, official creditors' committees are unlikely to form in consumer cases. Of the 782 cases in the Success Study's random sample, debtors checked the "Consumer/Non-Business" box on the petition in 102 cases.⁶⁵ An official creditors' committee formed in only one, or less than 1%, of those 102 cases. By comparison, a committee formed in 141, or 21%, of the 680 cases in which the debtor checked the "Business" box on the petition to describe the nature of its debts.⁶⁶ If Congress sought to increase oversight over chapter 11 debtors for cases in which creditors' committees were unlikely to form, then excluding consumer debtors from the Code's definition of a small business debtor made little sense.

In addition, confusion by debtors about how to classify debts or failure by debtors to correctly describe their status on the petition, schedules, or statements militate against the use of a "business-or-commercial-activities" qualifier in the Code's small business definition.⁶⁷ Prior to BAPCPA's enactment, a debtor who checked both "Consumer/Non-Business" for the nature of its debts and "Debtor is a small business as defined in 11 U.S.C. § 101" likely caused nothing more than head scratching among the lawyers in the Office of the United States Trustee ("OUST"). But, the stakes are higher post-BAPCPA.

⁶⁴ See BAPCPA House Report, *supra* note 38, at 19 (stating small business cases are less likely to have official creditor committees and BAPCPA requires "more active[] monitor[ing] by United States trustees and bankruptcy courts").

⁶⁵ Not all debtors in the random sample that identified their liabilities as "Consumer/Non-Business" were really consumer debtors. For whatever reason, a number of debtors provided conflicting information on the petition about their business versus consumer status. See, e.g., Voluntary Petition, *In re Vitello's, Inc.*, No. 04-38148 (Bankr. E.D. Va. Aug. 27, 2004) (Docket No. 1) (corporation checked "Corporation" for "Type of Debtor," "Consumer/Non-Business" for "Nature of Debts," and "Debtor is a small business as defined in 11 U.S.C. § 101"); Voluntary Petition, *In re Akingbade*, No. 04-28660 (Bankr. D. Md. Aug. 9, 2004) (Docket No. 1) (individual debtor checked "Consumer/Non-Business" for "Nature of Debts" and "Debtor is a small business as defined in 11 U.S.C. § 101"); Voluntary Petition, *In re Doyle*, No. 04-00524 (Bankr. D. D.C. Mar. 30, 2004) (Docket No. 1) (individual debtor checked "Individual" and "Partnership" for "Type of Debtor," "Consumer/Non-Business" for "Nature of Debts," and elected treatment as small business debtor).

⁶⁶ In 2004, the voluntary petition required the debtor to check one of two boxes—"Consumer/Non-Business" or "Business"—to describe the nature of its liabilities. The current form of the voluntary petition requires the debtor to check one of two boxes which describe the debtor's debts as "primarily consumer" or "primarily business." See Voluntary Petition, *supra* note 53 and accompanying text.

⁶⁷ See *supra* note 65 and accompanying text. Compare Voluntary Petition, *In re Witherspoon*, No. 04-12437 (Bankr. S.D. Ala. Apr. 27, 2004) (Docket No. 1) (checking "Consumer/Non-Business" box for Nature of Debts), with Schedules D–F, *In re Witherspoon*, No. 04-12437 (Bankr. S.D. Ala. Apr. 27, 2004) (Docket No. 1) (listing majority of liabilities as owed by debtor's business—Witherspoon Landscape Center).

Suppose a debtor files for chapter 11, checks the "Debtor is a small business debtor" box on the petition, but subsequently determines that it made a mistake in doing so. Filing an amended petition and checking "Debtor is not a small business debtor" does not transform the debtor's case into a non-small business case.⁶⁸ Except in a case in which committee formation changes a debtor's small business status, the bankruptcy court must make a determination of whether the debtor's case qualifies as a non-small business case.⁶⁹ Even if the bankruptcy court agrees with the debtor's efforts to change its small business designation, the court also must decide whether the change in designation applies prospectively or retroactively. That determination—whether to apply the change-in-designation prospectively or retroactively—can have far-ranging consequences.

In *In re Childs*, Eddie and Glenda Childs filed for chapter 11 and initially identified themselves as small business debtors.⁷⁰ A year later, after having proposed a plan of reorganization, the Childs filed a document with the court changing their designation to a non-small business.⁷¹ Taking up the question of the Childs' status in chapter 11, the bankruptcy court first found that the debtors were not small business debtors because their primary activity consisted of owning or operating real property.⁷² It then held that their original designation as a small business was *void ab initio*.⁷³ Voiding the debtors' original small business designation was critical to keeping the Childs' case in bankruptcy. Under the Code, cause for dismissal includes the failure to "file or confirm a plan" within the time periods fixed by the Code.⁷⁴ While the Childs had proposed a plan of reorganization, the bankruptcy court had failed to confirm the plan within the 45-day window applicable to small business debtors.⁷⁵

⁶⁸ See, e.g., *In re Root Rents*, 420 B.R. 28, 40 (Bankr. D. Idaho 2009) (footnote omitted) (stating that debtor may amend its designation but "it may not be entitled to operate under that amended statement until it demonstrates that its original statement was incorrect").

⁶⁹ See FED. R. BANKR. P. 1020(a) (2011) (stating with exception of Bankruptcy Rule 1020(c), governing impact of creditor committee appointments, debtor's case is treated in accordance with debtor's designation "unless and until the court enters an order finding that the debtor's statement is incorrect").

⁷⁰ No. BR 09-33970, 2010 WL 5108754 (Bankr. D. Utah Dec. 9, 2010). The Childs did not complete the small business designation on the petition, but did subsequently file a "small business election," even though BAPCPA had eliminated the small business election. *Id.* at *1-2, 4; see also Carlson & Hayes, *supra* note 3, at 679 (footnotes omitted) (noting "most important change in the definition of 'small business' debtor is that small business treatment is no longer elective").

⁷¹ *In re Childs*, 2010 WL 5108754, at *2.

⁷² *Id.* at *3.

⁷³ *Id.* at *5.

⁷⁴ 11 U.S.C. § 1112(b)(4)(J) (2006).

⁷⁵ *In re Childs*, 2010 WL 5108754, at *3. Section 1129(e) of the Code provides that "[i]n a small business case, the court shall confirm a plan . . . not later than 45 days after the plan is

Suppose that the bankruptcy court had held that the Childs were not small business debtors but had applied that holding prospectively, as have other bankruptcy courts.⁷⁶ The Childs' case then would have been subject to the Code's small business provisions *prior* to the bankruptcy court's order changing the designation to a non-small business case. As a result, the bankruptcy court would have failed to confirm the debtors' plan of reorganization within the 45-day window applicable to small business debtors and the United States trustee or any party in interest could have moved for dismissal of the case for "cause."

The *Childs* case involved a change in designation based on the real property exclusion, not the commercial-or-business-activities proviso, in the Code's small business definition.⁷⁷ Nonetheless, *Childs* is important because it reveals the traps for the unwary lurking in a seemingly simple check box on the voluntary petition. Changing the debtor's designation later in the case may carry with it harsh and untoward consequences. Such consequences might make sense if chapter 11 consumer cases differed in important respects from small business cases. But, the concerns underlying the small business reforms apply with equal vigor to business *and* consumer debtors.

Eliminating the commercial-or-business-activities proviso accomplishes several goals. First, it reduces the harsh consequences flowing from debtor mistakes about consumer versus business status. Second, it simplifies the definition. If consumer and business debtors alike are covered by the Code's small business language, then there is no need for the Code's current awkward parenthetical aside on affiliated debtors. Finally, and most importantly, the change better aligns the Code's definition with the cohort of cases at risk for chapter 11 failure.

2. The Real Property Exclusion

a. Did Congress Really Mean It?

The Code excludes from the pool of small business debtors any debtor whose primary activity is the ownership or operation of real property. Yet, when Congress adopted this exclusion back in 1994 when it added the small business election, it failed to define the phrase "primary activity is the business of owning or operating real property."⁷⁸ Congress did not rectify the oversight when it amended the small business definition as part of BAPCPA's small business amendments.

The Bankruptcy Code does define the term "single asset real estate" or SARE.

filed unless the time for confirmation is extended in accordance with section 1121(e)(3)." 11 U.S.C. § 1129(e).

⁷⁶ See *In re Childs*, 2010 WL 5108754, at *4–5 (discussing split of authority on whether change in small business designation applies prospectively or retroactively).

⁷⁷ *Id.* at *3.

⁷⁸ See 1994 Act, *supra* note 9, at § 217(a), 108 Stat. at 4127.

The term "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.⁷⁹

There is an obvious overlap between the Code's definition of SARE and the real property exclusion in the Code's "small business debtor" definition. Yet, it is clear that Congress did not intend the two categories to be co-extensive.

Congress created the small business election with the passage of the 1994 Act.⁸⁰ The election contained the current exclusion for debtors whose primary activity entails owning or operating real property.⁸¹ The 1994 Act also defined, for the first time, the term "single asset real estate."⁸² Therefore, had Congress intended to exclude only single asset real estate debtors from the purview of the small business debtor reforms, it easily could have done so.

Instead, Congress chose a phrase—primary activity—that subsumes within it a "single asset real estate" debtor but also reaches more broadly to cover debtors whose business activities would not otherwise satisfy the Code's definition of a single asset real estate case. A SARE debtor must derive substantially all its gross income from a single piece of land or a real property project on which no other substantial business is conducted.⁸³ Thus, the SARE debtor's primary activity is the business of owning or operating real property, which, in turn, excludes the SARE debtor from the pool of small business debtors.⁸⁴

⁷⁹ 11 U.S.C. § 101(51B) (West 2012).

⁸⁰ See 1994 Act, *supra* note 9, at § 217(e), 108 Stat. at 4127–28 (codifying small business election).

⁸¹ See *id.* at § 217(a), 108 Stat. at 4127 ("'[S]mall business' means a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) . . .").

⁸² See *id.* at § 218(a), 108 Stat. at 4128 (defining single asset real estate as "real property constituting a single property or project . . . which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto"); see also COLLIER ON BANKRUPTCY, ¶ 101.LH[5] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2012), available at LEXIS, 2–101 Collier on Bankruptcy P 101.LH (stating that 1994 Act added definition for "single asset real estate").

⁸³ 11 U.S.C. § 101(51B) (2006) (enumerating restrictions and requirements regarding single asset real estate debtors).

⁸⁴ See, e.g., *In re Castle Horizon Real Estate, LLC*, No. 09–05992–8–JRL, 2010 WL 3636160, at *2 (Bankr. E.D.N.C. Sept. 10, 2010) (noting that for debtor that designated case

A case, however, may not be a SARE yet still qualify for the real property exclusion. For example, suppose the debtor owns three separate parcels of real property, all in different locations, but earns all its income from renting these three properties.⁸⁵ The debtor's case is not a SARE because the real property is not a "single property or project."⁸⁶ Nonetheless, the debtor is not a small business debtor because its primary activity is the business of owning and renting out real property.⁸⁷

The legislative history for the 1994 Act is of little assistance in explaining why Congress chose to exclude certain real property debtors from the definition of a small business debtor and why it decided *not* to frame the exclusion by using the newly-minted definition of a SARE. The "primary activity" proviso first appeared in legislation proposing a "chapter 10" pilot program for small business debtors.⁸⁸ Testimony from members of the American College of Real Estate Lawyers in House hearings held in 1992 on proposed changes to the Code, including the chapter 10 pilot program, sheds some light on the real property exclusion.

The definition of small business in S. 1985 provides that a "person whose primary activity is the business of owning or operating real property and activities incidental thereto" is not eligible for the new small business Chapter 10. We support the inclusion of similar language in any version of Chapter 10 which your Subcommittee may adopt. . . . If lenders to real estate debtors are subject to Chapter 10, the result will be stricter credit standards and fewer loans for even well conceived [sic] real estate projects.

Non-recourse lending is almost exclusively limited to real estate. Chapter 11 contains two provisions that provide protections to the non-recourse lenders. . . . Chapter 10 has no comparable

as single asset real estate on petition, court had "significant reservations about whether the debtor's designation as a small business at the outset of th[e] case was correct").

⁸⁵ See *In re J & D Inv. Props., Inc.*, No. 10-31668-H3-11, 2010 WL 2572998, at *1-2 (Bankr. S.D. Tex. June 3, 2010).

⁸⁶ See *id.* at *2.

⁸⁷ See *id.*

⁸⁸ See *The Bankruptcy Amendments Act of 1993: Hearing on S. 540 Before the S. Subcomm. on Courts and Admin. Practice of the S. Comm. on the Judiciary*, 103d Cong. 413-15 (1993) (noting opposition to creation of chapter 10); S. REP. NO. 103-168, at 7-13 (1993) (defining small business and setting forth provisions of temporary new chapter 10 for small business); S. REP. NO. 102-279, at 5-13 (1992) (setting forth provisions of proposed chapter 10). See also Hon. A. Thomas Small, *If You Fix It, They Will Come - A New Playing Field for Small Business Bankruptcies*, 79 AM. BANKR. L.J. 981, 981-83, 987-94 (2005) (summarizing briefly history of attempts to create small business chapter and setting forth proposal for chapter 11S for small businesses).

provisions. Thus, Chapter 10 . . . materially increases the risk taken by a non-recourse lender.⁸⁹

Thus, there was some logic to the exclusion of real property debtors from the definition of a small business debtor in the proposals to create a chapter 10 pilot program.

But, chapter 10 never became law.⁹⁰ Instead, in the 1994 Act Congress used the "small business debtor" definition proposed for chapter 10 and imported it almost verbatim into chapter 11.⁹¹ If the protection of non-recourse lenders was the reason for the real property exclusion in chapter 10, that reason no longer applied in chapter 11. Yet, no other reason for the exclusion appears in the legislative history. Moreover, nothing in the legislative history explains why Congress opted for the "primary activity" exclusion rather than the newly-defined term "SARE." What is likely is that in 1994 Congress simply lifted the definition of a small business debtor from the chapter 10 proposals without giving much thought to whether the real property exclusion made sense in the context of chapter 11.

What is more baffling, however, is Congress' decision to retain the "primary activity" exclusion when it enacted BAPCPA in 2005. The Commission's "small business" definition contained no real property exclusion. In fact, the Commission defined a small business debtor to *include* "any single asset real estate debtor as defined in 11 U.S.C. § 101(51B), regardless of the amount of such debtor's liabilities."⁹² Congress, however, did not adopt the Commission's "small business

⁸⁹ 1992 Hearings, *supra* note 22, at 319–20 (prepared statement of Richard R. Goldberg, President of the American College of Real Estate Lawyers, and Walter J. Taggart, Professor, Villanova Law School).

⁹⁰ Concerns about the constitutionality of the proposed pilot program emerged during Congressional hearings. The fact that the new chapter 10 would apply in only eight judicial districts led some, including the National Bankruptcy Conference, to question "whether a substantive bankruptcy law [could] apply in particular judicial districts without violating the command of Article I, Section 8, Clause 4 of the Constitution that Congress enact uniform laws on the subject of bankruptcies." *The Bankruptcy Amendments Act of 1993: Hearing on S. 540 Before the Subcomm. on Courts and Admin. Practice of the S. Comm. on the Judiciary*, 103d Cong. 117 (1993) (emphasis in original) (prepared statement of position of the National Bankruptcy Conference).

⁹¹ Compare, e.g., 1994 Act, *supra* note 9, at § 217(a), 108 Stat. at 4127, and H.R. REP. NO. 5116, at 22 (1994), with S. REP. NO. 103-168, at 160 (1993). Only two differences distinguished the definition in Senate Bill 540, which proposed a chapter 10 pilot program, from the definition that Congress adopted in the 1994 Act: the liability limit and the liability modifier "noncontingent." Senate Bill 540 had a \$2.5 million liability cutoff while Congress pared that amount down to \$2 million in the 1994 Act. Congress also added the word "noncontingent" to describe the debtor's aggregate secured and unsecured debts.

⁹² 1997 COMMISSION REPORT, *supra* note 5, at 618. Professor Robert Lawless argues that the "primary activity" exception was "apparently meant to dovetail with the statutory

debtor" definition and nothing in the legislative history explains the retention of the real property exclusion in BAPCPA's "small business debtor" definition.⁹³ Therefore, the real property exclusion, which may have made sense in the context of a separate bankruptcy chapter for small business debtors, ended up in the Code's current "small business debtor" definition.

Why does it matter? The absence of a definition for the phrase "primary activity is the business of owning or operating real property" creates uncertainty. Uncertainty, in turn, not only fosters litigation, but also wastes time and resources. The United States trustee and chapter 11 debtors must determine, on a case-by-case basis, what are the exact contours of the Code's real property exclusion. Thus, time better spent on negotiating a plan or evaluating a debtor's prospects for success in chapter 11 is diverted to threshold questions about the applicability of the Code's small business provisions.

b. The United States Trustee

The voluntary petition requires chapter 11 debtors to check one of two mutually exclusive boxes identifying themselves as either small business debtors or non-small business debtors.⁹⁴ The United States trustee has 30 days from the conclusion of the first meeting of creditors to object to the debtor's designation.⁹⁵ The debtor's case, however, proceeds according to the debtor's designation as either a small or non-small business, until the bankruptcy court "enters an order finding that the debtor's statement is incorrect."⁹⁶

definition of 'single asset real estate' and make single asset real estate cases mutually exclusive from small business bankruptcies." Robert M. Lawless, *Small Business and the 2005 Bankruptcy Law: Should Mom and Apple Pie Be Worried?*, 31 S. ILL. U. L.J. 585, 589 (2007) (footnote omitted). Citing to an article co-authored by Judge Thomas Carlson and Jennifer Frasier Hayes, Professor Lawless notes the Commission's "intention that single-asset real estate cases *be excluded* entirely from the statutory definition of small business debtors." *Id.* at 589 n.19 (emphasis added). Yet, the Commission expressed no such intention. See 1997 COMMISSION REPORT, *supra* note 5, at 312 (explaining that "proposal on small businesses applies . . . to all single asset real estate cases, regardless of size"). Moreover, in their article, Judge Carlson and Ms. Hayes stated that "the Commission recommended that all debtors whose primary business is the ownership of real estate *be subject* to the small business reforms." Carlson & Hayes, *supra* note 3, at 653 (emphasis added).

⁹³ See Lawton, *supra* note 11, at 993–94 n.49 (providing Commission's definition for "small business debtor").

⁹⁴ See Voluntary Petition, *supra* note 53. The debtor that designates itself as a small business debtor also should check the box indicating that its non-contingent, liquidated liabilities, excluding insider and affiliate debts, do not exceed \$2,490,925. See *id.*

⁹⁵ See FED. R. BANKR. P. 1020(b) (2011). See *infra* notes 191–93 and accompanying text for a discussion of the exception to this 30-day objection rule.

⁹⁶ FED. R. BANKR. P. 1020(a).

If the debtor checks the "single asset real estate" box on the first page of the voluntary petition,⁹⁷ then it also will check that it is not a small business debtor.⁹⁸ The consequences flowing from a "single asset real estate" designation are sufficiently burdensome as to ensure that a debtor would not lightly select this designation in an attempt to avoid the Code's small business debtor provisions.⁹⁹ But, what of the business debtor that is not a SARE? Suppose a business debtor schedules liabilities of \$1.5 million but checks the box on the petition indicating that it is *not* a small business debtor. If no committee is appointed and the debtor has no affiliates, then the debtor's designation as a non-small business debtor must rest on the real property exclusion.

How does the United States trustee determine whether the debtor qualifies for the exclusion and, thus, is not a small business debtor? The debtor is not required to explain why it has concluded that its primary activity is the business of owning or operating real property. Information about the debtor's real property activities may appear in any one of several different places in the debtor's early filings in its chapter 11 case. For example, Schedule A requires the debtor to provide a description and location of its real estate holdings, including the value of the property.¹⁰⁰ But, this information alone tells attorneys in the OUST nothing about the relative importance of the debtor's real estate holdings to the debtor's overall business activities.¹⁰¹ Schedule I requires individual debtors to list the sources of

⁹⁷ See Voluntary Petition, *supra* note 53. The petition directs the debtor to "Check one box" under "Nature of Business" and "single asset real estate" is one of the options available.

⁹⁸ But see *In re Castle Horizon Real Estate, LLC*, No. 09-05992-8-JRL, 2010 WL 3636160, at *2 (Bankr. E.D.N.C. Sept. 10, 2010) (expressing "significant reservations" about debtor's designation of itself as small business debtor given that debtor had also designated itself SARE because Code's definition of small business debtor excludes debtors whose primary activity is owning or operating real property).

⁹⁹ The debtor in a single asset real estate case within 90 days of filing its voluntary petition either must file a plan of reorganization with a reasonable chance of confirmation within a reasonable time or start monthly payments equal to the "nondefault contract rate of interest" on the value of the secured creditor's interest in the real property. See 11 U.S.C. § 362(d)(3) (2006). Failure to do so may result in a lift of the automatic stay on the real property for the benefit of the creditor holding a claim on that real property. Eliminating the "primary activity" exclusion will require conforming amendments to § 362(d)(3). Otherwise, a SARE debtor that qualifies as a small business under the revised definition faces conflicting plan proposal periods—90 days under § 362(d)(3) and 300 days under § 1121(e)(2).

¹⁰⁰ See Official Form 6, Schedule A, COLLIER PAMPHLET EDITION, PART 2: BANKRUPTCY RULES, at F-32 (2011).

¹⁰¹ See, e.g., Schedule A, *In re Jackson*, No. 04-30197 (Bankr. D. Conn. Jan. 15, 2004) (Docket No. 1) (listing debtor as owner of four pieces of real property with total value of \$287,000).

their monthly income, including "Income from real property."¹⁰² But, only individuals, not artificial entities, have to complete Schedule I.¹⁰³

Moreover, suppose an individual debtor has a 9-to-5 job but also earns significant income from rental property? The pre-BAPCPA case of *In re DuPont*¹⁰⁴ highlights the problems confronting the United States trustee in evaluating whether debtors satisfy the real property exclusion.¹⁰⁵ In September 2004, Robert and LaVerne DuPont jointly filed for relief under chapter 11.¹⁰⁶ Robert served as Executive Director of River of Life Ministries while LaVerne worked in maintenance at the Ministries' office.¹⁰⁷ In the year that the DuPonts filed for bankruptcy, they earned \$49,000 from their respective jobs at the River of Life Ministries and \$102,600 from renting out four pieces of real estate to the Ministries.¹⁰⁸ What was the debtors' primary activity? Was it the activity to which they devoted most of their work time, i.e., their 9-to-5 jobs at the River of Life Ministries? Or, was it the activity that generated two-thirds of their yearly gross income, i.e., the real property rentals?¹⁰⁹

The *DuPont* case also points out the difficulty of accurately identifying debtors that may satisfy the real property exclusion. On their Schedule I, the DuPonts put

¹⁰² See Official Form 6, Schedule I, COLLIER PAMPHLET EDITION, PART 2: BANKRUPTCY RULES, at F-46 (2011).

¹⁰³ See *id.*

¹⁰⁴ No. 04-31275 (Bankr. W.D. Mo. Sept. 27, 2004).

¹⁰⁵ See also *infra* notes 121–26 and accompanying text for a discussion of the real property exclusion and the *In re Newton* case.

¹⁰⁶ See Docket, *In re DuPont*, No. 04-31275 (Bankr. W.D. Mo. Sept. 27, 2004).

¹⁰⁷ See Schedule I, *In re DuPont*, No. 04-31275 (Bankr. W.D. Mo. Sept. 27, 2004) (Docket No. 1).

¹⁰⁸ See Statement of Financial Affairs at Q1, Q2 & Q18(a), *In re DuPont*, No. 04-31275 (Bankr. W.D. Mo. Sept. 27, 2004) (Docket No. 1).

¹⁰⁹ One could argue that the DuPonts are not small business debtors because they are not "engaged in commercial or business activities," as required by § 101(51D) of the Bankruptcy Code. But this argument begs the question. If the DuPonts' primary activity was the owning or operating of real property, then they were engaged in business activities. Even if the DuPonts' primary activity was *not* the ownership or operation of real property, nothing requires the debtor's "commercial or business activities" to be the exclusive or even primary activity in which the debtor engages. See Lawless, *supra* note 92, at 588 (noting statutory language "could sweep even individuals with a small amount of self employment income"). In fact, nothing in the Code requires the debtor to still be engaged in business activities at the time of filing in order to qualify as a small business debtor. See Collier Definition, *supra* note 35, at 101-201-202 (stating "nothing in the legislative history [] suggest[s] that . . . the small business amendments should not apply" to debtor that had accumulated less than \$2.343 million [currently \$2,490,925] in debt from business activities but had terminated those activities prior to filing).

"0" under "Income from real property."¹¹⁰ Their rental income only showed up on the Statement of Financial Affairs ("SFA"). The SFA's Question 1 on "Income from employment or operation of business" showed pre-bankruptcy income for 2004 of \$47,000 for LaVerne and \$2,000 for Robert.¹¹¹ Question 2 on "Income other than from employment or operation of business" revealed that over the same time period debtors had earned \$102,600 from a "Lease on real estate."¹¹²

Did Congress really intend for attorneys and staff in the OUST to root through pages of schedules and debtor statements, computing percentages of income derived from a debtor's employment versus its real property activities? It is doubtful. So how does the United States trustee decide when to object to a debtor's non-small business designation when that designation rests on the real property exclusion? It is possible that examiners in the OUST rely on simple proxies, such as words in the debtor's name that indicate real property management or development, e.g., Commercial Lessors¹¹³ or Clemrose Properties,¹¹⁴ the debtor's self-identification as a SARE,¹¹⁵ or other easily obtained information from the petition indicating that the debtor's business is real estate, e.g., selling vacant lots in a residential subdivision.¹¹⁶ The absence of any case law on what constitutes the debtor's "primary activity" seven years after BAPCPA's enactment strongly suggests that the players in the bankruptcy system—the OUST and debtors alike—are using these easy markers to determine which debtors qualify for the real property exclusion.¹¹⁷

If indeed this is the case, the practice makes sense. The OUST has limited resources and a number of additional responsibilities under BAPCPA.¹¹⁸ In

¹¹⁰ See Schedule I, *In re DuPont*, No. 04-31275 (Bankr. W.D. Mo. Sept. 27, 2004) (Docket No. 1).

¹¹¹ See Statement of Financial Affairs at Q1, *In re DuPont*, No. 04-31275 (Bankr. W.D. Mo. Sept. 27, 2004) (Docket No. 1).

¹¹² See *id.* at Q2.

¹¹³ See *In re U.S. Commercial Lessors, Ltd.*, No. 04-11882 (Bankr. W.D.N.Y. Mar. 19, 2004).

¹¹⁴ See *In re Clemrose Props., Inc.*, No. 04-47852 (Bankr. D.N.J. Dec. 2, 2004).

¹¹⁵ See, e.g., Statement of Financial Affairs at Q. 18b, *In re Phoenix eSuites, LLC*, No. 04-06327 (Bankr. D. Ariz. Apr. 28, 2004) (Docket No. 6).

¹¹⁶ See, e.g., Voluntary Petition, Exh. A, *In re Trade Partners Gateway Ctr., LLC*, No. 04-07121 (Bankr. W.D. Mich. June 8, 2004) (Docket No. 1) (stating debtor "[o]wns single [sic] family residential subdivision in Pinal County, Arizona containing vacant lots to be sold for development").

¹¹⁷ I searched "primary activity" and 101(51D)" in both LEXIS' bankruptcy court database and the general federal court database. The search produced only six decisions, none of which explained what constitutes a debtor's "primary activity" for purposes of the real property exclusion.

¹¹⁸ See UNITED STATES DEP'T OF JUSTICE, UNITED STATES TRUSTEE PROGRAM FISCAL YEAR 2009 BUDGET REQUEST (2008) [hereinafter OUST BUDGET] (observing OUST's "responsibilities in terms of implementing the provisions of BAPCPA have grown

addition, only smaller debtors—those with liabilities under \$2,490,925—benefit from litigating the exact contours of the real property exclusion.¹¹⁹ Any debtor with aggregate liabilities in excess of the Code's debt limit automatically falls outside the pool of small business debtors. It is only those debtors who might benefit from the real property exclusion that have an incentive to push the boundaries of what constitutes a debtor's "primary activity." Unfortunately, it is exactly this category of debtor—the small chapter 11 debtor—that likely lacks the wherewithal to litigate the issue.

c. Chapter 11 Debtors

The small business debtor's obligations begin with the filing of its voluntary petition. The debtor must append to its petition "its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return."¹²⁰ In order to comply with the Code's requirements, however, the debtor must be able to determine its status as a small versus non-small business debtor. That determination is not difficult if the debtor's case qualifies as a SARE or if the debtor is engaged only in the real estate business. What happens, however, when the debtor's case is not so easily categorized? Take the pre-BAPCPA case of *In re Newton*¹²¹ as an example.¹²²

Gary Newton filed for relief under chapter 11 to stop a foreclosure from proceeding on one of two pieces of rental property that he owned.¹²³ Newton operated a chiropractic clinic and earned \$1675 per month from the business, while bringing in at least \$3095 per month from his rental properties.¹²⁴ Newton

significantly" and "workload associated with the new provisions [has] increased extensively").

¹¹⁹ 11 U.S.C. § 101(51D) (West 2012).

¹²⁰ 11 U.S.C. § 1116(1)(A) (2006). If the debtor has not prepared these various financial statements and has not filed a federal return, then it must append a statement verifying under penalty of perjury that it does not have these documents. *See id.* at § 1116(1)(B) (2006).

¹²¹ No. 04-53451 (Bankr. N.D. Cal. May 27, 2004).

¹²² *Newton*, like *DuPont*, was filed prior to BAPCPA. Thus, in neither case did the United States trustee object to the debtor's designation as a small business, nor is there any analysis of the small business debtor issue. Both cases, however, nicely illustrate the ambiguities inherent in the real property exclusion in the definition of a small business debtor.

¹²³ *See* Motion by United States Trustee to Convert or Dismiss Chapter 11 Case, at 3, *In re Newton*, No. 04-53451 (Bankr. N.D. Cal. Aug. 9, 2004) (Docket No.18) (citation omitted) (stating that "[d]ebtor [had] testified at his 341 meeting that he had filed bankruptcy to stop the foreclosure on the Potrero Drive Property"). Debtor owned two pieces of rental property—one at Potrero Drive and the second on Casselman Drive. *See id.* at 2.

¹²⁴ *See id.* at 4. There was a discrepancy of \$1500 between what the debtor said he earned from the rental properties and what the debtor had listed on his Schedule I. *See id.* at 4 n.2 (stating that debtor had listed \$4695 per month in rental income on Schedule I but testified to only \$3095 in such income at his section 341 meeting). The \$1675 earned at the

scheduled liabilities of \$1,562,788, approximately \$440,000 lower than the then-existing \$2 million cutoff for small business debtors,¹²⁵ and the United States trustee did not appoint an official committee of unsecured creditors.

Suppose Newton had filed for bankruptcy post-BAPCPA. He could check the box "Debtor is not a small business debtor as defined in 11 U.S.C. § 101(51D)" *only* if his primary activity was the business of owning or operating real property.¹²⁶ Should his attorney recommend that he do so? The consequences of a debtor's failure to properly designate itself as a small business debtor are not trivial, as evidenced by *In re Display Group, Inc.*, a post-BAPCPA case.¹²⁷

The *Display Group* debtor filed for chapter 11 and checked the box on the petition indicating it was not a small business debtor.¹²⁸ Two months later, the United States trustee timely objected to the debtor's non-small business designation.¹²⁹ In mid-November, more than four months after the debtor had filed its chapter 11 case, the bankruptcy court concluded that the debtor's designation on the petition as a non-small business debtor had been "incorrect" and that the debtor was indeed a small business debtor.¹³⁰ The court then found that the various deadlines for a small business debtor ran from the date on which the debtor had filed its chapter 11 petition, not from the date of the court's holding that the debtor's case *now* was a small business one.

Here, Congress in the Bankruptcy Code did not differentiate between deadlines for cases initially filed as small business cases and those determined to be such. The exclusivity period in Section 1121(e)(1) and the outside deadline for debtor to file a plan in

chiropractic business was a net income figure; nonetheless, even taking account of taxes, the chiropractic income would have been substantially less than the rental property income.

¹²⁵ See Summary of Schedules, *In re Newton*, No. 04-53451 (Bankr. N.D. Cal. June 29, 2004) (Docket No. 16).

¹²⁶ Newton initially checked the "Individual" and "Consumer/Non-Business" boxes on the petition. See Voluntary Petition, *In re Newton*, No. 04-53451 (Bankr. N.D. Cal. May 27, 2004) (Docket No. 1). He subsequently filed an amended petition on which he checked "Individual" and "Business" and also the box indicating that he was a small business debtor. See Amended Voluntary Petition, *In re Newton*, No. 04-53451 (Bankr. N.D. Cal. June 29, 2004) (Docket No. 14). In 2004, the debtor could elect small business treatment; Newton chose not to do so. See *id.*

¹²⁷ No. 10-75502, 2010 WL 4777550 (Bankr. E.D.N.Y. Nov. 16, 2010).

¹²⁸ *Id.* at *1.

¹²⁹ Any party in interest or the United States trustee may object to the debtor's designation on the petition as either a small business debtor or a non-small business debtor. See FED. R. BANKR. P. 1020(b) (2011). The objection must be made within 30 days of the conclusion of the section 341 first meeting of creditors. See *id.* The U.S. trustee concluded the section 341 meeting in *Display Group* on August 20, and filed its objection to debtor's designation on September 14. See *In re Display Group Inc.*, 2010 WL 4777550, at *2.

¹³⁰ *In re Display Group, Inc.*, 2010 WL 4777550, at *5.

Section 1121(e)(1) are expressly stated as running from the order for relief, which is the petition date in a voluntary case. 11 U.S.C. § 1121(e)(1), (2).

* * *

Thus, in this case, Debtor's deadlines run from July 15, 2010, the petition date, not the date of this decision or the order hereon.¹³¹

In doing so, the *Display Group* court changed the deadlines under which the debtor had to operate. The Code provides that in a voluntary small business case, a plan must be filed no later than 300 days from the petition filing date.¹³² "There is no similar Code-imposed bar for non-small business debtors."¹³³ What happens if no plan is filed within 300 days in a small business case? Section 1121, which contains the 300-day deadline, does not specify. Such failure, however, satisfies the Code's definition of "cause" for dismissal of a chapter 11 case.¹³⁴ Thus, 124 days into the case, the *Display Group* debtor discovered that it had only 176 days left of the 300-day deadline in which to propose a plan of reorganization, or risk dismissal from chapter 11.¹³⁵

While the debtor in *Display Group* is not particularly sympathetic—the debtor's liabilities clearly fell under the statutory debt limit and the debtor was not involved in the real property business—the implications of the court's decision are unsettling. For example, what happens in a case in which the United States trustee takes longer than it did in the *Display Group* case to conclude the section 341 meeting? The Bankruptcy Rules run the objection period to the debtor's designation from the conclusion of the section 341 meeting. The court in *Display Group* noted the problem, but left resolution of the issue to another case and another day.

This Court needs [sic] not and does not reach the issue of a case in which an objection to a non-designation is filed after the deadline to file a plan under Section 1121(e)(2) has expired. If the Section 341 meeting has not been concluded within 270 days after the petition date, the Rule 1020(b) deadline to object, which runs 30 days after the conclusion of the meeting of creditors, would not

¹³¹ *Id.* at *5.

¹³² See 11 U.S.C. § 1121(e)(2) (2006).

¹³³ *In re Roots Rents, Inc.*, 420 B.R. 28, 35 (Bankr. D. Idaho 2009).

¹³⁴ See 11 U.S.C. § 1112(b)(4)(J) (stating "cause" for dismissal includes "failure to . . . file or confirm a plan, within the time fixed by this title").

¹³⁵ From the petition filing date of July 15 to November 16, the date of the court's decision, is 124 days, leaving 176 days in the 300-day plan-proposal deadline.

have run before a small business debtor's 300 day deadline to file a plan.¹³⁶

Not all bankruptcy courts faced with the question of the retroactive versus prospective application of the Code's small business provisions have ruled as the court did in *Display Group*. In fact, there is a split of authority on the issue.¹³⁷ But a split of authority creates uncertainty about the consequences for those debtors wishing to invoke the real property exclusion. That uncertainty, coupled with the absence of a definition in the Code for what constitutes a debtor's "primary activity," no doubt limits the cases in which a debtor relies on the exclusion to avoid small business status. But, if Congress' goal was to narrowly circumscribe the use of the real property exclusion, then why not simply define the phrase "primary activity" in order to accomplish that end?

d. Summary

It is unclear why Congress created the real property exclusion in the Code's "small business debtor" definition. The legislative history suggests that Congress mistakenly incorporated the exclusion, which was intended for a small business chapter that never materialized. Congress' failure to define the contours of what constitutes a debtor's "primary activity" makes it difficult to predict whether the exclusion applies to a particular debtor. This uncertainty, in turn, makes it harder to accomplish the early sorting of debtors called for by BAPCPA's small business reforms.

3. Complex Counting Rules

A chapter 11 debtor is not a small business debtor if it has "aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the order for relief in an amount not more than \$2,490,925 (excluding debts owed to 1 or more affiliates or insiders)."¹³⁸ On its Summary of Schedules, the debtor reports its total liabilities.¹³⁹ That figure, however, is not the one that determines the debtor's liabilities for purposes of the Code's small business definition. Instead, to arrive at the "small business" figure, the debtor must deduct the following:

¹³⁶ *In re Display Group, Inc.*, 2010 WL 4777550, at *5 n.9.

¹³⁷ See *supra* note 76 and accompanying text.

¹³⁸ 11 U.S.C. § 101(51D)(A) (West 2012). See *supra* note 36 regarding adjustment of the Code's dollar figures.

¹³⁹ See Official Form 6, Summary of Schedules, COLLIER PAMPHLET EDITION, PART 2: BANKRUPTCY RULES, at F-30 (2011) [hereinafter Summary].

- (1) contingent debt;
- (2) unliquidated debt;
- (3) liabilities owed to affiliates; and
- (4) liabilities owed to insiders.

Is such a complicated liability definition necessary? The short answer is "no." In Part 3(a), I summarize the results of a recently published study, which shows that while liability size predicts plan success, it does so regardless of whether liabilities include or exclude contingent and unliquidated debt. In Part 3(b), I explain how the exclusion of affiliate and insider debt rarely affects liability totals and how requiring the deduction of such debts likely accomplishes little besides confusion and extra work for the players in the bankruptcy system.

a. Contingent and Unliquidated Debt

In the Success Study,¹⁴⁰ I evaluated the impact of committee formation and liability size—two statutory criteria for small business debtors—on chapter 11 success, defined as plan confirmation and successful plan performance. The Success Study is based on a sample of 782 chapter 11 debtors drawn from the entire population of chapter 11 cases filed in 2004, one year before BAPCPA's passage.¹⁴¹ The results of the Success Study confirm both Congress' and the Commission's intuition—small-liability debtors struggle in chapter 11 to confirm and successfully perform plans. In fact, debtors with liabilities in excess of \$2 million—the liability limit in effect in 2004—confirmed and successfully performed plans at significantly higher rates than did debtors whose liabilities fell below that \$2 million threshold.¹⁴² What is even more interesting, however, is that these findings obtained regardless of whether the analysis was done using only debtors' non-contingent and liquidated liabilities or debtors' total liabilities, as reported on the Summary of Schedules.¹⁴³

The question ultimately is one of costs and benefits. Imagine a non-real-property debtor whose Summary of Schedules lists \$2.5 million in liabilities, \$500,000 of which is contingent, and whose petition indicates that debtor is not a small business debtor. The debtor must schedule its liabilities and complete a Summary of Schedules¹⁴⁴ that not only provides a total liability figure but also breaks down that liability total by secured, unsecured priority, and general

¹⁴⁰ See generally Lawton, *supra* note 11.

¹⁴¹ See *id.* at 1003.

¹⁴² See *supra* note 36 for an explanation of the dollar adjustment made to the Code's definition of a small business debtor.

¹⁴³ See Lawton, *supra* note 11, at 1027; see also *id.* at 995–1005 for an explanation of the study's design.

¹⁴⁴ See 11 U.S.C. § 521(a)(1)(B)(i) (2006) (stating that debtors "shall file . . . schedule of assets and liabilities"); FED. R. BANKR. P. 1007(b)(1)(A) (2011).

unsecured status.¹⁴⁵ The required schedules or statements do not require the debtor to provide a total of its contingent and unliquidated debts. Instead, Schedules D, E, and F—the debtor's liability schedules—contain columns labeled "Contingent" or "Unliquidated."¹⁴⁶ For each page of each liability schedule, the debtor checks the column next to any debt that it contends is contingent or unliquidated.¹⁴⁷ Are we to believe that attorneys and staff in the OUST are paging through reams of debtors' schedules for cases on the cusp of the liability cutoff in order to determine whether those debtors' liabilities—without contingent and unliquidated debt—fall under the small business liability threshold? It seems unlikely, given limited resources and the additional responsibilities created for the OUST by BAPCPA.¹⁴⁸

BAPCPA's statutory framework created a triaging system. Debtors with low prospects for chapter 11 success are identified early in the case and channeled into the pool of small business debtors. Complicating that process—by requiring the subtraction of unliquidated and contingent debt from debtor liability totals on the Summary of Schedules—undermines the triaging system. Moreover, based on the

¹⁴⁵ See Summary, *supra* note 139.

¹⁴⁶ See, e.g., Official Form 6, Schedule D, COLLIER PAMPHLET EDITION, PART 2: BANKRUPTCY RULES, at F-37 (2011). On Schedule D, debtor lists its secured debt. See *id.* There is a third column for disputed debts that is not relevant to this discussion. See *id.* It is clear that some debtors do not understand the meaning of "unliquidated." See, e.g., Schedules, *In re Mark Edgil & Assocs., Inc.*, No. 04-85645 (Bankr. N.D. Ala. Dec. 30, 2004) (Docket No. 17) (providing specific amounts for all liabilities but checking "unliquidated" next to each amount); Schedule D, *In re McDowell*, No. 04-18329 (Bankr. D. Ariz. Nov. 28, 2004) (Docket No. 21) (listing \$836,554.50, which was all of debtor's secured debt, as unliquidated); Schedule F, *In re Butterfly Int'l LLC*, No. 04-08747 (Bankr. M.D. Tenn. Oct. 8, 2004) (Docket No. 38) (listing debt owed to A.I.R. Gospel in amount of \$52,522.61 but checking not only "unliquidated" but also "contingent" and "disputed"). It is unlikely that these debtors were engaged in strategic reporting of their liabilities. See *infra* note 147. They could have achieved the same strategic advantage by checking only the "disputed" column on their schedules. By checking "unliquidated" for debts with established and to-the-penny amounts, these debtors signaled that they did not understand the difference between "disputed" and "unliquidated." See *In re Huelbig*, 299 B.R. 721, 724–25 (D.R.I. 2003) (discussing confusion between disputed and unliquidated debt in context of eligibility requirements for chapter 13).

¹⁴⁷ There may be a strategic reason for checking debts as contingent, unliquidated, or disputed. Doing so in a chapter 11 case forces the creditor whose debt is so listed to file a proof of claim, when it otherwise would not have to do so, or risk losing its right to vote on the plan and share in any distributions thereunder. See Anne Lawton & Lynda Oswald, *Scary Stories and the Limited Liability Polluter in Chapter 11*, 65 WASH. & LEE L. REV. 451, 521 (2008). Post-BAPCPA, a debtor must weigh this strategy against the possibility of lowering its liabilities sufficiently to fall under the liability cutoff for small business debtors.

¹⁴⁸ See OUST BUDGET, *supra* note 118, at 5 (noting increase in workload due to BAPCPA's reforms).

existing empirical evidence, it does so without improving the ability to identify those debtors at risk for failure in chapter 11.

b. Affiliate and Insider Debt

The Code also excludes from the liability calculation any debts that the chapter 11 debtor owes to affiliates or insiders.¹⁴⁹ The exclusion is not limited to affiliates or insiders that also are chapter 11 debtors.

The problem with the affiliate and insider exclusion is a practical one. How does a creditor or the United States trustee determine whether a debtor's designation as a non-small business is incorrect based on the debtor's failure to deduct affiliate or insider debt?¹⁵⁰ Take the pre-BAPCPA case of *In re Memphis Bar-B-Q Company, Inc.*, as an example.¹⁵¹

The debtor's Summary of Schedules showed \$2,297,560.51 in liabilities,¹⁵² which was approximately \$300,000 higher than the \$2 million liability cutoff in the Code's small business definition in 2004. No debtor affiliates had pending bankruptcy cases,¹⁵³ but Memphis Bar-B-Q had scheduled more than \$941,000 in liabilities to corporate insiders and affiliates.¹⁵⁴ Thus, Memphis Bar-B-Q qualified as a small business debtor: it was in the restaurant, not the real property, business, and its liabilities *exclusive* of affiliate and insider debt were less than \$1.4 million. The voluntary petition in 2004 contained two boxes under the heading "Chapter 11 Small Business": (1) "Debtor is a small business as defined by 11 U.S.C. § 101"; and (2) "Debtor is and elects to be considered a small business under 11 U.S.C. §

¹⁴⁹ See 11 U.S.C. § 101(2) (2006) (defining affiliate); *id.* at § 101(31) (defining insider).

¹⁵⁰ See FED. R. BANKR. P. 1020(b) (2011) (providing United States trustee or "party in interest," which Code defines to include creditors, may object to debtor's designation as small or non-small business).

¹⁵¹ No. 04-10671 (Bankr. E.D. Va. Feb. 18, 2004).

¹⁵² See Summary of Schedules, *In re Memphis Bar-B-Q Co.*, No. 04-10671 (Bankr. E.D. Va. Mar. 19, 2004) (Docket No. 51).

¹⁵³ See Voluntary Petition, *In re Memphis Bar-B-Q Co.*, No. 04-10671 (Bankr. E.D. Va. Feb. 18, 2004) (Docket No. 1) [hereinafter *Memphis Petition*] (stating "N.A." on line asking for pending bankruptcy filings by affiliates).

¹⁵⁴ Approximately \$841,000 was owed to Jane C. Ware and CF Ltd., each of which held 25% of the firm's voting shares and, thus, qualified as affiliates under 11 U.S.C. § 101(2)(A), which provides that an entity owning more than 20% of a debtor's voting stock is an affiliate. See List of Equity Security Holders, *In re Memphis Bar-B-Q Co.*, No. 04-10671 (Bankr. E.D. Va. Mar. 19, 2004) (Docket No. 53) (listing stock ownership of firm); Schedule D, *In re Memphis Bar-B-Q Co.*, No. 04-10671 (Bankr. E.D. Va. Mar. 19, 2004) (Docket No. 51) (listing secured debt of \$70,000 to Jane C. Ware); Schedule F, *In re Memphis Bar-B-Q Co.*, No. 04-10671 (Bankr. E.D. Va. Mar. 19, 2004) (Docket No. 51) (listing more than \$700,000 in unsecured debts to Jane C. Ware and CF Ltd.).

1121(e) (Optional)."¹⁵⁵ While Memphis Bar-B-Q did not have to elect small business treatment, it did have to check the box indicating it was a small business. It did not do so.¹⁵⁶

Determining Memphis Bar-B-Q's status as a small business was time-intensive and not a simple process. The debtor had no pending affiliate bankruptcy filings and, therefore, correctly noted "N.A." in the applicable space on the voluntary petition.¹⁵⁷ The Code, however, requires the deduction of affiliate or insider debt, regardless of whether the affiliate or insider has a pending bankruptcy case. Corporate debtors must file with their voluntary petition a corporate ownership statement,¹⁵⁸ and within fourteen days of filing the petition, such debtors in chapter 11 must file a list of equity security holders.¹⁵⁹ In addition, the Statement of Financial Affairs requires debtors to disclose the names, addresses, and the percentage ownership stake in the debtor for current partners, officers, directors, and shareholders.¹⁶⁰

Armed with this information, I checked the schedules for liabilities owed to any affiliate, e.g., a shareholder owning 20% or more of Memphis Bar-B-Q's stock,¹⁶¹ or debts owed to insiders, e.g., any of the officers or directors listed on the Statement of Financial Affairs.¹⁶² Memphis Bar-B-Q had 40 pages of scheduled liabilities. Luckily, the firm alphabetized the names of their creditors, making the process of locating affiliates and insiders somewhat easier. Unfortunately, not all chapter 11 debtors are so organized. Yet, even with an alphabetized set of schedules, the process was not simple; the liabilities owed to various affiliates and insiders of Memphis Bar-B-Q were scattered throughout the schedules, appearing on both Schedules D and F.

Once again, are we to believe that the United States trustee has the time and resources to devote to such labor-intensive activities? It is unlikely, which suggests that in practice, it is the total on the Summary of Schedules on which the parties rely for determining small business debtor status. Of course, the United States trustee may ask about affiliate and insider debt at the first meeting of creditors. But,

¹⁵⁵ See, e.g., Memphis Petition, *supra* note 153.

¹⁵⁶ See *id.*

¹⁵⁷ See *id.* and accompanying text.

¹⁵⁸ See FED. R. BANKR. P. 1007(a)(1) (2011).

¹⁵⁹ See *id.* at 1007(a)(3).

¹⁶⁰ See Official Form 7, Statement of Financial Affairs Q.21, COLLIER PAMPHLET EDITION, PART 2: BANKRUPTCY RULES, at F-56, 64 (2011).

¹⁶¹ An affiliate includes any "entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor." 11 U.S.C. § 101(2)(A) (2006). See also *infra* note 189 and accompanying text for a discussion of the Code's "affiliate" definition.

¹⁶² The Code's definition of a corporate insider includes directors and officers of the debtor. See 11 U.S.C. § 101(31)(B)(i)–(ii).

at that point, the parties already are at least a month into the case.¹⁶³ One goal of the small business reforms was to shepherd out of chapter 11 more quickly those debtors with no prospects for rehabilitation. Delaying identification of these debtors undermines that goal.

If attorneys in the OUST actually are engaging in the time- and labor-intensive process of identifying affiliate and insider debt, the evidence from the random sample suggests that doing so is a waste of time and resources. In only ten cases, or 1.3% of the 782 cases in the random sample, did the deduction of affiliate or insider debt matter to the determination of the debtor's status as a small versus non-small business debtor.¹⁶⁴ It is possible that this figure is higher, given the difficulty of identifying all debtor affiliates and insiders using the unhelpful and limited affiliate and insider disclosures required of debtors on their statements and schedules in 2004.¹⁶⁵ But, many of these same disclosure limitations still exist post-BAPCPA, because nothing in the Code, the bankruptcy rules, or the bankruptcy forms requires debtors to provide a total of their affiliate and insider debt.

c. Summary

The various qualifiers to the Code's liability cutoff for small business debtors needlessly complicate early identification of those debtors most at risk for chapter 11 failure. BAPCPA's small business reforms did not bring changes to the schedules and statements necessary to easily identify contingent, unliquidated, affiliate, or insider debt.

Moreover, the existing empirical evidence indicates that sorting out contingent, unliquidated, affiliate and insider debt is largely a wasted effort producing no better predictions of chapter 11 success. Eliminating these unnecessary qualifiers from

¹⁶³ Compare FED. R. BANKR. P. 2003(a) (stating "United States trustee shall call a meeting of creditors to be held no fewer than 21 days and no more than 40 days" after filing of petition in voluntary case), with FED. R. BANKR. P. 1007(c) (providing with limited exceptions debtor must file all its schedules and statements in voluntary case within 14 days of filing its bankruptcy petition).

¹⁶⁴ These findings include an analysis of the impact of affiliate and insider debt on groups of affiliated debtors. See *infra* note 184 and accompanying text. In three cases in the random sample, the debtor checked the "Over \$100 million" range on the petition and I did not have schedules available. While it is possible that in one or more of these three cases the debtor had \$98 million of affiliate or insider debt, it is unlikely. Hence, I counted these cases as not affected by the deduction of affiliate or insider debt. See Lawton, *supra* note 11, at 1003–04 n.105, and accompanying text.

¹⁶⁵ For example, the husband of a corporate officer is an insider. See 11 U.S.C. § 101(31)(B)(vi). If the husband loaned money to the corporation, then the loan is an insider debt. But, if the husband's last name differs from that of his wife and there is no description besides "loan" on the schedules, it would be impossible from the schedules alone to identify the loan as an insider debt.

the statutory liability formula will simplify the sorting process and align the Code's language with what is likely current practice without losing the ability to accurately identify those debtors with the weakest prospects for success in chapter 11.

4. Unintended Consequences and Creditor Committee Appointment

The Code provides that a debtor is not a small business debtor if the United States trustee appoints a sufficiently active and representative committee of unsecured creditors pursuant to § 1102(a)(1). But, the United States trustee does not operate in the six federal judicial districts in Alabama and North Carolina. Instead, the Bankruptcy Administrator handles cases in those districts.¹⁶⁶

Suppose a limited liability company that is not in the real estate business and that has \$2 million in total liabilities files for relief under chapter 11 in the Southern District of Alabama. Sufficient interest exists among the debtor's unsecured creditors and the bankruptcy court orders the appointment of an official committee of unsecured creditors.¹⁶⁷ But, because the United States trustee did not appoint the committee, as the statutory language provides, the debtor is a small business debtor under a technical reading of the Code's language.¹⁶⁸

¹⁶⁶ See *About the United States Trustee Program and Bankruptcy*, THE U.S. DEPT OF JUSTICE, http://www.justice.gov/ust/uo/ust_org/index.htm (last visited Aug. 19, 2012),

¹⁶⁷ See, e.g., Order Appointing Creditors' Committee, *In re Alabama Septic Tanks, LLC*, No. 04-12560 (Bankr. S.D. Ala. June 10, 2004) (Docket No. 14). In Alabama and North Carolina, the bankruptcy court orders the appointment of an official creditors' committee. See FED. R. BANKR. P. 9035 Notes of Advisory Committee on Rules - 1991, *reprinted in* 11 U.S.C. app. Fed R. Bankr. P. and Official Bankr. Forms § 9035 (2006) (explaining that in North Carolina and Alabama, certain bankruptcy rules are "partially inconsistent with the provisions of the Code" and noting "[t]he court, rather than the United States trustee, appoints committees in . . . chapter 11 cases" to explain reference in Rule 2007 to only United States trustee). Compare Notice of Appointment of Committee of Unsecured Creditors, *In re KB Toys*, No. 04-10120 (Bankr. D. Del. Jan. 23, 2004) (Docket No. 157) (notice from United States trustee stating "I hereby appoint the following persons to the Committee of Unsecured Creditors"), with Order Appointing Creditors' Committee, *In re PLEJ's Linen Supermarket SoEast Stores LLC*, No. 04-31383 (Bankr. W.D.N.C. May 4, 2004) (Docket No. 58) (stating matter had come before court on Bankruptcy Administrator's recommendation and that "the Court acting pursuant to its authority under 11 U.S.C. § 1102 . . . HEREBY ORDERED that the following creditors [were] to constitute the Official Committee of Unsecured Creditors in this Case").

¹⁶⁸ See Collier Definition, *supra* note 35, at 101-203 (footnote omitted) (stating "a debtor in a chapter 11 case in Alabama or North Carolina may be a 'small business debtor' even though a creditors' committee is active in the case").

Surely this was not Congress' intent. Congress' concern with small business debtors was the absence of oversight due to the lack of interest by creditors in serving on the official creditors' committee.¹⁶⁹

Most chapter 11 cases are filed by small business debtors. Although the Bankruptcy Code envisions that creditors should play a major role in the oversight of chapter 11 cases, this often does not occur with respect to small business debtors. The main reason is that creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases.¹⁷⁰

An official creditors' committee provides this critical oversight function, even if the United States trustee does not appoint the committee. Therefore, I recommend deleting the reference to the United States trustee and mimicking the language used in Federal Rule of Bankruptcy Procedure 1020—"[i]f a committee of unsecured creditors has been appointed under § 1102(a)(1)"¹⁷¹—to avoid the problem posed by the more restrictive language of the Code's current definition.

5. What Predicts Chapter 11 Success?

In the Success Study, I examined chapter 11 success rates for a random sample of almost 800 debtors drawn from the entire population of chapter 11 cases filed in calendar year 2004.¹⁷² I grouped the random sample debtors along two of the Code's current criteria for a small business debtor—committee formation and liability size.¹⁷³ I looked at both initial success rates—whether the debtor confirmed a plan—and ultimate success rates—whether the court dismissed or converted the case post-confirmation, or the debtor subsequently re-filed for bankruptcy.¹⁷⁴ The results of the Success Study demonstrate that committee formation and liability size *each* independently predicts initial and ultimate success in chapter 11.¹⁷⁵

¹⁶⁹ See Lawton, *supra* note 11, at 995 (footnote omitted).

¹⁷⁰ BAPCPA House Report, *supra* note 38, at 19.

¹⁷¹ FED. R. BANKR. P. 1020(c) (2011).

¹⁷² See Lawton, *supra* note 11, at 995. For the analysis of committee formation, the random sample consisted of 798 debtors. See *id.* at 1003. For the liability analysis, there were 782 debtors in the random sample. See *id.* at 1004. The difference in the sample sizes was due to the fact that I could not obtain reliable liability information for sixteen debtors. See *id.* at 1010.

¹⁷³ See *id.* at 1005.

¹⁷⁴ See *id.* at 1002. I included in the success figures any debtor that confirmed a plan, regardless of whether it was a plan of reorganization, liquidation, or partial reorganization and partial liquidation. See *id.* at 995–1005 for an explanation of the study's methodology.

¹⁷⁵ See *id.* at 1025.

First, cases in which an official committee of unsecured creditors formed had both initial and ultimate success rates that were significantly higher statistically ($p < 0.001$)¹⁷⁶ than cases in which no committee formed.¹⁷⁷ Second, cases in which debtors' liabilities exceeded \$2 million—the liability cutoff in 2004 for small businesses—also had initial and ultimate success rates that were significantly higher statistically ($p < 0.001$) than cases in which the debtors' liabilities were \$2 million or less.¹⁷⁸ As discussed earlier, the liability results obtained regardless of whether liability totals included or excluded contingent and unliquidated debt.¹⁷⁹

In order to test the screening ability of the "small business debtor" definition proposed in this Article, I coded the 782 cases in the random sample using only committee formation and debtors' liabilities to make the small business determination. I coded as a small business any case in which no committee formed *and* the debtor had liabilities of \$2 million or less. If an official committee formed or the debtor's liabilities exceeded \$2 million, I coded the case as a non-small business. I did the small business coding using the scheduled total liabilities of each debtor in the 782-case random sample. Contingent, unliquidated, affiliate and insider debts were not deducted.

I then measured initial and ultimate success rates using the small business coding described above. The Chi-square test for independence was used for all statistical analyses performed.¹⁸⁰ The statistical testing was performed at the 0.05 significance level; thus, a result is statistically significant if the test's associated p-value is less than 0.05. The first thing to note about the results is that 63% of the debtors in the random sample qualified as a small business using only committee formation and scheduled liabilities as the sorting criteria.¹⁸¹ Second, more than 48% of the non-small business debtors confirmed plans, while only a little over a quarter of the small business debtors did so.¹⁸² Moreover, as the results in Column C of Table 2 demonstrate, this difference in initial success rates is statistically significant. The findings are similar for ultimate success rates. In twenty-one small

¹⁷⁶ A p-value "usually expresses the probability that results at least as extreme as those obtained in a sample were due to chance." SARAH BOSLAUGH & PAUL ANDREW WATTERS, STATISTICS IN A NUTSHELL 145 (Mary Treseler ed., 2008).

¹⁷⁷ See Lawton, *supra* note 11, at 1008, Tables 1 & 2.

¹⁷⁸ See *id.* at 1012–14, Tables 4 & 5.

¹⁷⁹ Compare *id.* at 1012, Table 4, with *id.* at 1014, Table 5. The study also includes an analysis of the liability data using the Commission's \$5 million liability cutoff and multiple comparisons of the \$2 million versus \$5 million threshold. See *id.* at 1017–1024, Tables 6–9.

¹⁸⁰ I used IBM's SPSS Statistics software Version 19 to perform the statistical testing reported in this Article.

¹⁸¹ If the debtor's contingent and unliquidated liabilities were deducted, the totals in Table 1 would change by 20 for each category: 509 small business debtors and 273 non-small business debtors. See *infra* Table 1.

¹⁸² See *infra* Chart 1; compare Column B, Table 2, with Column A, Table 2.

business cases, the debtor either re-filed for bankruptcy, or the bankruptcy court dismissed or converted the case post-confirmation. Thus, small business debtors had an ultimate success rate of only 21%, or less than half of the 43% ultimate success rate for non-small business debtors.¹⁸³ Once again, as Column C of Table 2 demonstrates, these differences are statistically significant.

In conclusion, the simplified definition of a small business debtor predicts both plan confirmation and successful plan performance. Non-small business debtors, defined as any debtor with an official creditors' committee and/or total liabilities in excess of the Code's liability cutoff, confirmed and successfully performed plans at significantly higher rates than did small business debtors, i.e., those debtors without an official committee and with liabilities below the Code's debt threshold.

Table 1. Small vs. Non-Small Business Debtors

	Number of Cases	Percentage of Total Cases
Small Business	489	62.5%
Non-Small Business	293	37.5%
Total Cases	782	100%

¹⁸³ See *infra* Chart 1; compare Column B, Table 2, with Column A, Table 2.

Chart 1. Small vs. Non-Small Business Success Rates

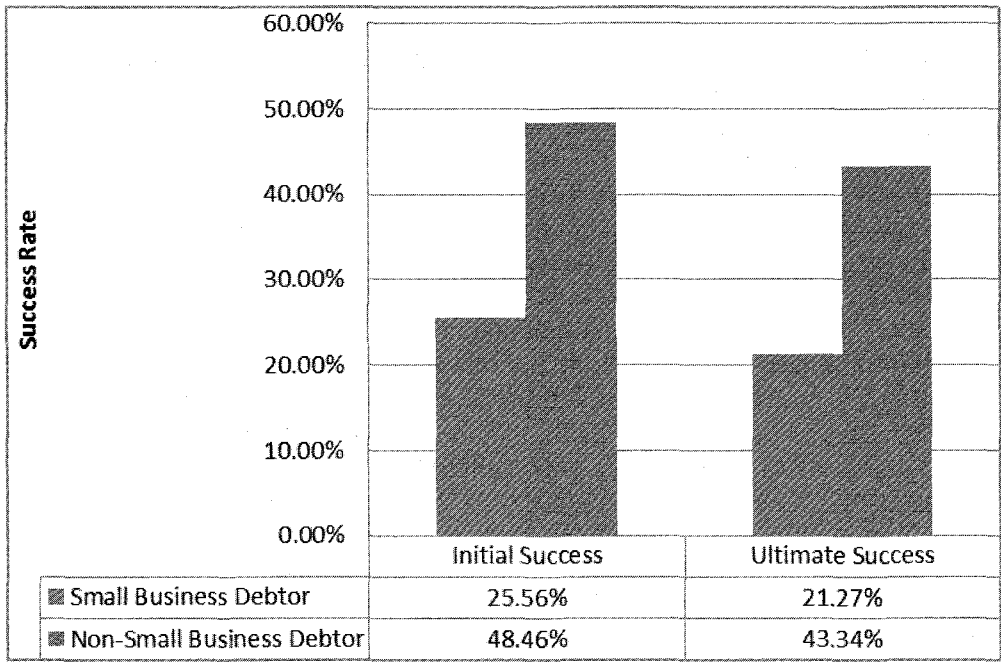


Table 2. Comparative Success Rates of Small and Non-Small Business Debtors

	A	B	C
	Small Business	Non-Small Business	Results
Initial Success Total Cases = 782	125/489 = 25.56%	142/293 = 48.46%	p < 0.001 Statistically significant higher rate of initial success for non-small business debtors
Ultimate Success Total Cases = 782	104/489 = 21.27%	127/293 = 43.34%	p < 0.001 Statistically significant higher rate of ultimate success for non-small business debtors

B. Subpart (B) of the Definition

My recommended changes to subpart (B) of the Code's small business definition involve the method for calculating group liabilities. First, there is no reason to require the subtraction of contingent and unliquidated debt from the debtor's scheduled liabilities. The statutory requirement is burdensome, and as both the Success Study and the statistical analysis in Part II.A.5 demonstrate, it is unnecessary. Debtors with more than \$2 million in liabilities (the 2004 statutory debt limit), regardless of whether contingent and unliquidated debt was excluded or included in debtor liability totals, confirmed and successfully performed plans at significantly higher rates than did debtors whose liabilities were \$2 million or less.

Second, in only four cases did subtraction of affiliate or insider debt determine a group of affiliated debtors' status as a small business debtor.¹⁸⁴ This finding is not surprising. Groups of affiliated debtors often involve large cases.¹⁸⁵ Either aggregate group liabilities—even accounting for inter-company loans and other insider and affiliate debt—easily exceed the statutory limit, or official creditors' committees form because more is at stake than would be in a smaller chapter 11 case.

Of course, eliminating the affiliate-and-insider-debt deduction will allow a few cases to slip through the cracks and qualify as non-small businesses. But, as the random sample analysis demonstrates, that number is small. Moreover, increased precision comes at a cost. Accurately accounting for all insider and affiliate debt is a time-consuming process. That process no doubt is simpler when a group of debtors files for bankruptcy because the debtors file their schedules at the same time, and in some cases on a consolidated basis.¹⁸⁶ Nonetheless, the Code's definition does not limit its affiliate-and-insider-debt deduction to debtor affiliates or insiders; it requires the subtraction of liabilities owed to any insider or affiliate, whether in bankruptcy or not. There is no one place on the current bankruptcy forms where debtors must disclose the *sum* of their affiliate and insider debt. On balance, the loss of precision in identifying small business debtors is more than

¹⁸⁴ The findings represent the results of deducting affiliate or insider debt only for groups of affiliated debtors. See 11 U.S.C. § 101(51D)(B) (2006); see also *supra* note 164 and accompanying text.

¹⁸⁵ See, e.g., *In re Footstar*, No. 04-22350 (Bankr. S.D.N.Y. Mar. 2, 2004) (lead case for chapter 11 filings by 2,529 affiliated debtors); Annex A to Voluntary Petition, *In re KB Toys, Inc.*, No. 04-10120 (Bankr. D. Del. Jan. 14, 2004) (lead case for chapter 11 filings by seventy affiliated debtors).

¹⁸⁶ For example, in the *Footstar* cases—2529 affiliated debtors filed for chapter 11—the debtors filed three sets of consolidated schedules based on the three corporate divisions. See Corporate Debtors' Schedules, *In re Footstar, Inc.*, No. 04-22350 (Bankr. S.D.N.Y. June 15, 2004) (Docket No. 684); Athletic Debtors' Schedules, *In re Footstar, Inc.*, No. 04-22350 (Bankr. S.D.N.Y. June 15, 2004) (Docket No. 686); Meldisco Debtors' Schedules, *In re Footstar, Inc.*, No. 04-22350 (Bankr. S.D.N.Y. June 15, 2004) (Docket No. 687).

offset by the time and resources necessary to obtain an accurate count of debtor liabilities in those very few cases where such liabilities affect the small business calculation.

CONCLUSION

There is an expression, drawn from a poem by Voltaire, that the "perfect is the enemy of the good."¹⁸⁷ It is an admonition not to allow the striving for perfection to interfere with obtaining a good, albeit less than perfect, result. In evaluating the "small business debtor" amendment proposed in this Article, it is important to be mindful of Voltaire's admonition.

The simplified "small business debtor" definition sorts chapter 11 debtors along two criteria that, when combined, predict both plan confirmation and successful plan performance. The amended definition makes the determination of who qualifies as a small business debtor simpler for debtors and the United States trustee alike. It dissolves the unfounded statutory distinction between consumer and business debtors. It removes the undefined "primary activity" qualifier, thereby eliminating the need to litigate over what business constitutes the debtor's primary activity of "owning or operating real property." The revised definition also simplifies the application of the Code's liability cutoff. Debtor confusion about the meaning of terms like "contingent" or "unliquidated",¹⁸⁸ and debtor misunderstanding about how to apply the Code's less-than-straightforward definition of an affiliate,¹⁸⁹ do not affect small business status under the proposed

¹⁸⁷ M. DE VOLTAIRE, *LA BEGUEULE*, CONTE MORAL A3 (1772) ("[L]e mieux est l'ennemi du bien."). A literal translation means "the best is the enemy of the good."

¹⁸⁸ See *supra* note 146 (citing cases of debtor confusion about what constitutes unliquidated debt).

¹⁸⁹ The Code's affiliate definition includes any entity that directly or indirectly "owns, controls, or holds with power to vote" 20% or more of the voting securities of the debtor, and any corporation in which 20% or more of the voting securities are held by the debtor or by an entity that owns 20% or more of the debtor's voting securities. 11 U.S.C. § 101(2)(A)–(B) (2006). Suppose Beta, Inc. owns 20% or more of the voting stock of Ajax, Inc., and also owns 20% of the debtor Zed Company. Both Ajax and Beta are affiliates of the debtor: Beta because it directly owns 20% of the debtor's stock, and Ajax, because it is a "corporation 20 percent" of whose voting stock is held by "an entity"—Beta—that owns 20% or more of the debtor Zed's shares. As this example demonstrates, unpacking the Code's affiliate definition is not simple; moreover, the example relies on only two of the four subsections of the Code's definition. Debtors are confused about simple matters, such as what constitutes an equity security, or how to treat membership interests in a limited liability company. See Lawton, *supra* note 11, at 1027 n.154 (citing cases from random sample in which debtor disclosures reveal confusion about what constitutes equity security or ownership interest in debtor). Basic confusion about what constitutes an equity security, in turn, affects the debtor's ability to accurately apply the Code's definition of an "affiliate."

revision. Moreover, debtors already have to report their total liabilities on the Summary of Schedules. Under the revised definition, creditors and the United States trustee need only compare that total against the current \$2,490,925 liability limit. Thus, the modified definition not only simplifies the task of sorting small from non-small businesses, but it also makes the sorting process less reliant on judicial interpretation and more on objectively verifiable facts.

Nonetheless, the proposed definition is not without its faults. Relying on creditor committee formation to determine small versus non-small business status has some pitfalls. The Code's small business reforms are triggered at petition filing.¹⁹⁰ At filing, however, the debtor does not know if a committee will form. What happens, then, if the debtor checks the "small business" box on the petition, because it otherwise qualifies as a small business debtor, but sufficient interest exists to form an official committee of unsecured creditors? Federal Rule of Bankruptcy Procedure 1020 creates an exception to the normal rule that the debtor's designation on the petition controls the case status until the bankruptcy court rules to the contrary.¹⁹¹ In cases in which committee formation *alone* changes a debtor's status as a small business, "[a]ppointment of a committee of unsecured creditors overrides the debtor's initial designation of itself as a small business debtor and the case proceeds as one not governed by the small business provisions."¹⁹² Thus, the rule reduces the normal delay that a judicial determination of non-small business status otherwise would necessitate.¹⁹³ Nonetheless, the time gap between petition filing and committee formation means that in some cases, i.e., those in which the debtor has less than \$2,490,925 in total liabilities, the debtor will have to comply

¹⁹⁰ See, e.g., 11 U.S.C. § 1116(1) (requiring small business debtor to attach certain financial information to petition).

¹⁹¹ See FED. R. BANKR. P. 1020(a) (2011). Rule 1020(a) provides that "[e]xcept as provided in subdivision (c)," the debtor's designation on the petition controls until a contrary finding by the bankruptcy court. *Id.*

¹⁹² 9 COLLIER ON BANKRUPTCY, ¶ 1020.04, at 1020-3 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009). Bankruptcy Rule 1020(c) does not specifically provide that a change in the debtor's status is automatic upon appointment of a committee. Instead, it states that if a committee is appointed, the case "proceed[s] as a small business case *only if, and from the time when*" the bankruptcy court enters an order finding that the committee is not sufficiently active and representative. FED. R. BANKR. P. 1020(c) (emphasis added). With regard to committee appointment, only two possibilities present themselves: either the United States trustee appoints a committee or the United States trustee proves unable to do so. If the court determines that the committee is not sufficiently active and representative, then going forward, the case is treated as a small business case. If no such determination is made, however, and a committee has been appointed, then the only status left *prior* to any court decision is that of a non-small business case. By negative implication, then, the bankruptcy rule provides that the chapter 11 case proceed as a non-small business case once a committee is appointed.

¹⁹³ See FED. R. BANKR. P. 1020(a).

with the Code's early reporting requirements for small business debtors even though, upon committee formation, the small business reforms no longer apply to the case.¹⁹⁴

Another issue is how to deal with cases in which the bankruptcy court determines that the committee appointed is "not sufficiently active and representative to provide effective oversight of the debtor"?¹⁹⁵ Suppose a debtor with less than \$2,490,925 in total liabilities files for relief under chapter 11. Under the revised definition, the case becomes one involving a small business debtor. If the United States trustee appoints a committee, the case then proceeds as a non-small business case. But, suppose that the United States trustee subsequently seeks a determination that the appointed committee is not sufficiently active and representative?¹⁹⁶ If the bankruptcy court agrees, the case then reverts to small business status. It is possible, then, that a case may change from small business (based on the petition designation) to non-small business (upon committee appointment) back to small business (upon a judicial finding of a non-active and non-representative committee). These back-and-forth changes in status upend the goal of identifying at-risk debtors early in the case in order to facilitate dismissal or conversion.¹⁹⁷

Some perspective is needed, however, on the scope of the potential problem. The absence of case law on the issue suggests that changes in small business status are rare based solely on a bankruptcy court's determination that a creditor committee is not sufficiently active and representative. The Success Study data provides further support for this conclusion. Of the 782 cases in the random sample, only thirty-nine or 5% of the cases had *both* an official creditors' committee *and* liabilities below the statutory debt threshold.¹⁹⁸ In other words, if BAPCPA had

¹⁹⁴ See 11 U.S.C. § 1116(1) (requiring small business debtor to attach to petition certain additional financial information).

¹⁹⁵ 11 U.S.C. § 101(51D)(A) (West 2012).

¹⁹⁶ See FED. R. BANKR. P. 1020(c) (setting forth procedure to determine whether committee is sufficiently active and representative).

¹⁹⁷ These changes in status also raise questions about how to apply the Code's deadlines for plan proposal and confirmation in small business cases. Because the United States trustee or a party in interest need raise the committee's ability to provide effective oversight "only within a reasonable time after the failure of the committee to be sufficiently active and representative," the case may be in bankruptcy as a non-small business case for some time prior to this determination. FED. R. BANKR. P. 1020(c). Yet, if the bankruptcy court finds that the committee is not providing effective oversight and, thus, the case reverts once again to small business status, the shortened deadline for plan proposal in small business cases may already have run. See 11 U.S.C. § 1121(e) (2006) (establishing 300-day deadline from petition filing for proposing plan in voluntary small business case).

¹⁹⁸ In none of the cases in the random sample did the bankruptcy court determine that the creditors' committee was not sufficiently active or representative, but in 2004, no such

been in effect in 2004, a change in status based on an inactive creditors' committee could have occurred in at most 5% of the cases. Moreover, that 5% figure assumes that in *every single* case with a creditors' committee and liabilities below the Code's liability threshold, the court would have determined that the committee was not sufficiently active and representative.

On balance, the possibility of delayed dismissal or conversion in a small, perhaps miniscule, percentage of chapter 11 cases is more than offset by the strong predictive power of committee formation on prospects for chapter 11 success. Further tinkering may produce a more perfect sorting mechanism. But, as Voltaire cautioned more than 225 years ago: "[L]e mieux est l'ennemi du bien."¹⁹⁹

requirement existed in the Code. Hence, the absence of such a finding is not surprising. See generally Lawton, *supra* note 11.

¹⁹⁹ See VOLTAIRE, *supra* note 187 and accompanying text.